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IN THE

Supreme Court of the United States

October Term, 1963
No. 777

AFFILIATED GOVERNMENT EMPLOYEES' DISTRIBUTING COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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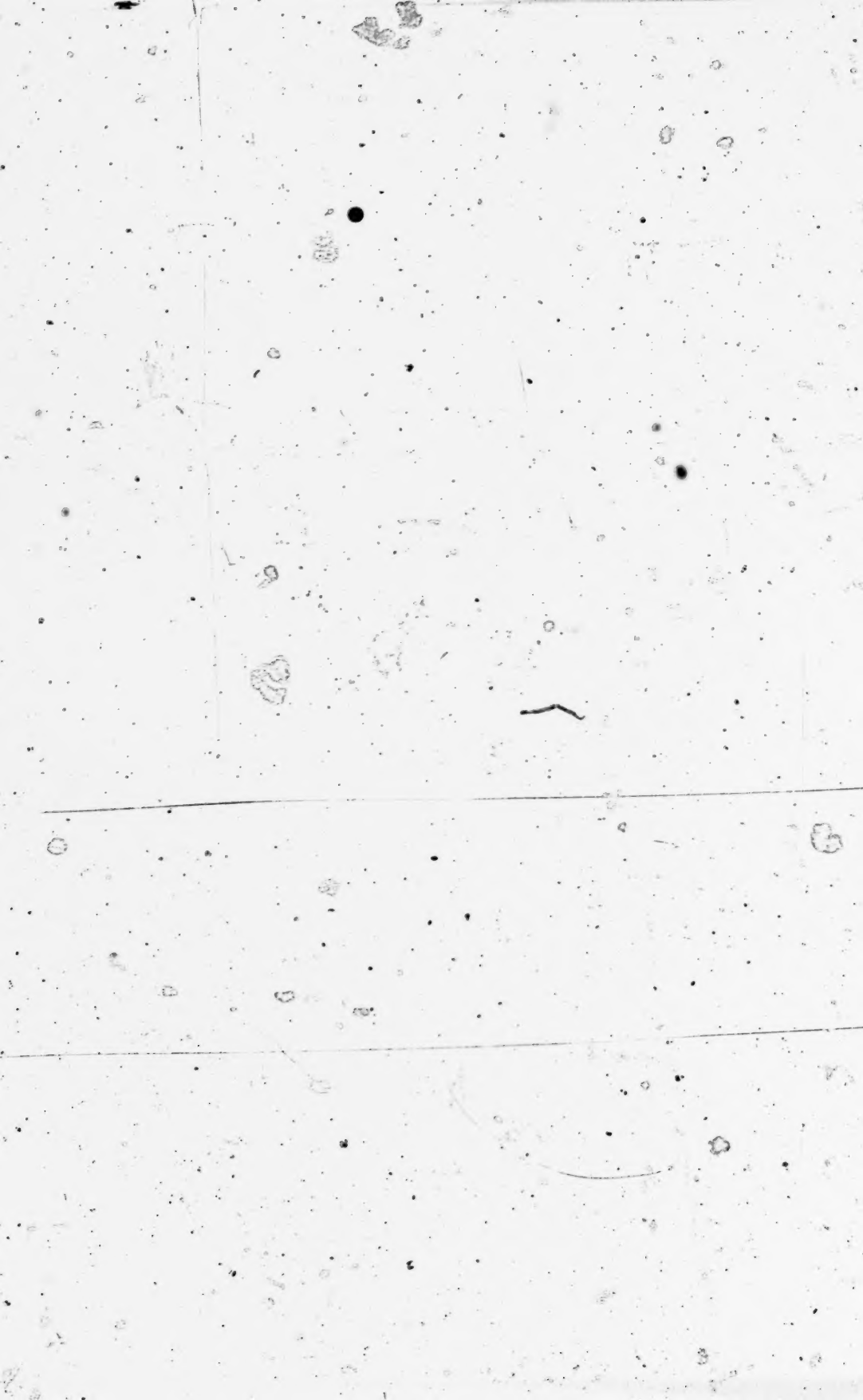

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Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on September 16, 1963.

Citations to Opinions Below.

The opinion of the Tax Court of the United States is reported in 37 T. C. 909, and is printed in Appendix C hereto, *infra*, page 16. The opinion of the United States Court of Appeals for the Ninth Circuit sustaining the decision of the Tax Court is printed in Appendix B hereto, *infra*, page 3, and is reported in 322 F. 2d 872 (1963). In a companion case, Federal Employees' Distributing Company v. United States of America, the United States District Court for the Southern District of California declined to follow the

Tax Court; and held for the taxpayer on substantially the same set of facts. The opinion of the United States District Court is reported in 206 F. Supp. 330 and is printed in Appendix E hereto, *infra*, page 36. The United States Court of Appeals for the Ninth Circuit overruled the United States District Court on the authority of the instant case. The opinion of the Circuit Court of Appeals in said companion case is reported in 322 F. 2d 891 (1963) and is printed in Appendix D hereto, *infra*, page 34.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on September 16, 1963, R. 184. An application for extension of time within which to file a petition for writ of certiorari was timely filed. The application was granted by the Honorable W. O. Douglas, Associate Justice of the Supreme Court of the United States on November 18, 1963, and Petitioner's time for filing this petition was extended to and including January 22, 1964. The Jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1).

Questions Presented.

1. Whether the imposition of an income tax on equity capital paid in to a nonstock corporation violates the provisions of Article I, Section 2, Clause 3 and Section 9, Clause 4 of the Constitution of the United States.

2. Whether amounts received by a nonstock corporation in exchange for its proprietary memberships constitute amounts received in exchange for stock within the meaning of Section 1032(a) and Section 7701(a)(7), Internal Revenue Code of 1954.

3. Whether the consideration by the Circuit Court of Appeals of matters outside the record resulted in a denial of due process of law to petitioner.

Constitution and Statutory Provisions Involved.

The provisions of the United States Constitution involved are Article I; Section 2, Clause 3 and Section 9, Clause 4 and the Sixteenth Amendment to the Constitution of the United States. The statutory provisions involved are Section 61(a)(1), Section 1032(a) and Section 7701(a)(7) of the Internal Revenue Code of 1954.

Statement.

On or about September 9, 1959, respondent delivered to petitioner his statutory notice of a proposed assessment of deficiencies in petitioner's federal corporate income taxes for its taxable years ending June 30, 1956, and June 30, 1957. Thereafter, on or about November 30, 1959, petitioner filed its petition with the Tax Court of the United States for re-determination of such deficiencies under the provisions of Section 6213(a) of the Internal Revenue Code of 1954.

In 1953, five hundred city employees of Oakland, California, primarily from that city's Police Department, contributed $2.00 apiece to the formation of petitioner as a nonstock membership-owned corporation under the General Nonprofit Corporation Laws of the State of California.*

*Under Section 9200 of the Corporations Code of the State of California, nonstock corporations are permitted to engage in business enterprises for profit. They are prohibited from distributing gains, profits or dividends except upon dissolution. Corporations engaging in such business enterprises, including petitioner, pay a full state and federal income tax on the profits arising out of the business enterprise.

The purpose of the incorporating members in forming petitioner was to provide a merchandising company that would enable its membership to buy merchandise at competitive retail prices. To undertake such a business enterprise, petitioner, like any corporation, required capital. Under California law and as a California nonstock corporation, petitioner could have "stock" in the primary sense of "capital."** It could not raise capital, however, by the issuance and sale of *shares* of stock (*California Corporations Code* Section 107), and it is in this sense that the word "nonstock" is applied to California corporations such as petitioner.

After its organization by Oakland city employees, petitioner corporation embarked on the merchandising business. Like any corporation, petitioner needed capital. As a nonstock corporation, it could not issue orthodox stock certificates to raise capital. In lieu thereof it sold memberships. These funds realized from the sale of memberships provided petitioner with its only capital, and these funds were employed by petitioner as capital. (R. 76-79.) *** The members received in exchange for their payments a proprietary interest in petitioner. There are no proprietary rights in petitioner except those vested in its members.

**"The word 'stock' is not uniformly used to designate the capital of a corporation, although its primary meaning is capital in whatever form it may be invested . . ."; *Wright v. Georgia R.R. & Banking Co.*, 216 U.S. 420, 424.

***In the companion case, Federal Employees Distributing Company, the government conceded that "there had been no other capital funds available to plaintiff [petitioner therein]", but denied that the membership certificate fees were paid-in capital, equity capital or capital. Federal Employees Distributing Company, Record, pp. 24-25.

The sale of a proprietary membership by petitioner involves a single nonrecurring payment made by an individual at the time he joins petitioner and receives in exchange his membership certificate. There are no dues or other periodic payments involved in the question before the Court. The funds received by petitioner from the sale of memberships were the capital with which petitioner corporation embarked on the merchandising business. These funds were used by petitioner to buy and stock inventory, rent stores, pay salaries, and were otherwise employed as capital is employed by any corporation embarking on a business enterprise. (R. 76.) If the venture had failed, the membership funds were the only risk capital available to pay creditors of petitioner corporation. However, the business enterprise thus commenced was successful. Substantial profits were earned, and upon these profits petitioner corporation has paid full State and Federal income taxes since the date of its formation. The single nonrecurring payment of a member has always been classified by petitioner as capital on its books of account. In 1959, six years after its incorporation, respondent proposed an assessment of income tax against the membership funds of petitioner. The essential question before the Court is whether petitioner corporation must pay an income tax on the receipt of a single nonrecurring payment made by an individual when he joins petitioner corporation and which provided petitioner nonstock corporation with its only paid in equity capital.

1. The Decision of the Court of Appeals Presents a Direct Conflict in Principle With Decisions of This Court and the Courts of Appeals for the Fifth and Tenth Circuits.

An income tax on the capital paid into a corporation by its stockholders or members is not authorized under the Sixteenth Amendment to the Constitution of the United States.

Section 2, Clause 3 and Section 9, Clause 4 of Article I of the United States Constitution prohibit the levy of a direct tax by the United States without apportionment among the several states according to the population. The imposition of a tax on the capital paid into a corporation is a direct tax.

In the case of *Eisner v. Macomber*, 252 U. S. 189 (1920), this Court held, and the law remains, that the Sixteenth Amendment to the Constitution of the United States excepts from Article 1, Section 2, Clause 3 and Section 9, Clause 4 of the Constitution, only such property as constitutes income in the commonly accepted meaning of the word "income" in the English language, and that Congress cannot levy an income tax on capital.

The Court states at page 206 of 252 U. S.:

> "A proper regard for its genesis, as well as its very clear language, requires also that this Amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

> "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

Subsequent decisions of the Court of Appeals for other Circuits, following the *Macomber* case, have reaffirmed the principle that an income tax could not constitutionally be imposed upon capital. Thus, the then Circuit Court of Appeals for the Fifth Circuit, in *Commissioner of Internal Revenue v. Fleming*, 82 F. 2d 324 (5th Cir. 1936), stated at page 326:

> "It must be always remembered that taxation under the Sixteenth Amendment can only be on income as distinguished from capital, on the increment of wealth realized by its conversion or by its use in conjunction with labor and not on the original capital."

And, in *Nicholas v. Fifteenth Street Inv. Co.*, 105 F. 2d 289 (10th Cir. 1939), the Tenth Circuit Court of Appeals states at 290:

> "... the power of the Congress to lay and collect taxes on income is confined to that which is actually and essentially income; and income, as thus used, means the gain derived from capital,

> from labor, or from both combined. The taxing power in respect to income cannot by legislative definition be extended beyond that scope. That which is not actually and essentially income cannot by definition be subjected to such a tax."

Reduced to the barest statement, petitioner's view is this: The capital of a corporation represents a pooling or a combining of capital of its individual stockholders or members. In this pooling or combining there is no element of *quid pro quo*, no rendering of service by the corporation or exchange of its property for the capital which is paid in by the corporation's stockholders or members. The share certificates or the memberships issued to the shareholders or members as an incident to the pooling or combining of their capital in the corporation are in the nature of receipts showing the fact of the pooling or combination of capital and, too, evidence their proprietary rights in the corporation. In this pooling of capital in the corporate receptacle there is no element or aspect which gives rise to the generation or realization of income on the part of the corporation. The corporation has simply been provided with capital wherewith to embark or enlarge upon the venture or activity for which it was formed.

What is said in the preceding paragraph in general terms applies specifically to the petitioner herein and to the funds, the membership fees, which were paid in to it by its members for their memberships. These funds represented and were petitioner's capital, the capital with which it commenced business and the capital which permitted it to carry on and expand its business.

Although the Court of Appeals avoided any discussion of the constitutional question urged upon it by

petitioner, implicit in its decision is a conflict in principle between decisions of this Court and other circuits. By its decision, the Court of Appeals has sanctioned the imposition of an income tax on petitioner's capital or capital stock. A tax so imposed is a direct tax, and its imposition is violative of the cited provisions of the Constitution of the United States.

2. The Decision of the Court of Appeals Ignored, and Failed to Dispose of, Petitioner's Argument That the Tax Sought to Be Imposed on Petitioner by Respondent Was Unconstitutional.

In the court below, petitioner urged, as a ground of reversal of the decision of the Tax Court, that the imposition of an income tax upon its membership funds was a tax on its capital; that that capital and its receipt by petitioner was not income under the Sixteenth Amendment to the Constitution, and accordingly that the imposition of such a tax would be an unconstitutional levy under Section 2, Clause 3, and Section 9, Clause 4, of Article I of the Constitution.

This argument of petitioner was wholly separate in principle and concept from its argument, under Section 1032(a) of the Internal Revenue Code—that petitioner's memberships were "stock" within the meaning of that Section and of Section 7701(a)(7) of the Internal Revenue Code. Petitioner's argument on the constitutional point was this in essence:

> Even if petitioner's memberships were not shares of stock within the statutory meaning and intent, nevertheless, and wholly apart from the statute, funds paid in to petitioner upon issuance of its proprietary memberships constituted petitioner's

paid in capital and were not items of income upon which a tax might be constitutionally levied under the Sixteenth Amendment to the Constitution.

The Court of Appeals ignored petitioner's constitutional argument. Its decision is based solely upon a finding adverse to petitioner's argument under the statute—a finding that the membership fees were not paid "in exchange for stock." Nowhere in the opinion of the court below is there reference to the status of the membership fees as capital in petitioner's hands, much less a reference to petitioner's constitutional argument.

Petitioner submits that it was entitled, as a matter of right, to a determination and a disposition by the Court of Appeals of the constitutional issue, reasonably and in good faith raised by petitioner in the proceedings below. It was the duty of the Court of Appeals to consider and to expressly accept or reject petitioner's constitutional argument; such action was essential to a proper disposition of the case. *Hepburn v. Griswold*, 75 U. S. 603, 611-612 (1869); *Bank of Hamilton v. Dudley*, 27 U. S. 492, 522 (1829); *Barr v. Matteo*, 355 U. S. 171 (1957).

3. The Questions Presented by This Petition Are of Substantial Importance in That They Affect Not Only Petitioner But Many Other Taxpayers Similarly Situated.

Of compelling significance is the impact which the Court of Appeals' decision has and will have on nonstock companies in the United States, including those in California. California and some eighteen other states of the Union authorize nonstock corporations to engage

in business enterprises.* Similar impact will be had upon an indeterminate number of trusts, partnerships, syndicates and other entities or groups which are or may hereafter become subject to corporate income tax liability as "associations" within the meaning of Section 7701(a)(7) of the Internal Revenue Code.

If left standing, the decision of the court below will have a material and adverse effect upon business operations of a substantial number of nonstock corporations and "associations." These, like conventional corporate business enterprises, require capital to initiate and carry on their business. If the acquisition of this capital is to be subjected to income tax, nonstock or non-corporate taxpayers within the described categories will

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*ALABAMA, Title 10 Code of Alabama, §203 *et seq.*, "Non-Profit Corporation Act."; COLORADO, Article 20 of Chapter 31 of Colorado Statutes, Section 30-20-1 to 30-20-7, "Corporation Not For Profit."; FLORIDA, Chapter 617 Florida Statutes, Section 617.01 to 617.26, "Corporations Not For Profit," §617.01(2); HAWAII, Title 23 Revised Laws of Hawaii, §§172-16, 17 and 18; ILLINOIS, Title 32 Illinois Statutes Annotated §163a; INDIANA, Burns Indiana Statutes Annotated, §25-507; *et seq.*; "General Not for Profit Corporation Act."; LOUISIANA, Section 12:101 to 12:155 of Louisiana Revised Statutes, "Non-Profit Corporations."; MICHIGAN, Section 21.118 *et seq.*, of Michigan Statutes Annotated, "Corporations Not for Pecuniary Profit."; MINNESOTA, Chapter 317 Minnesota Statutes Annotated, Section 317.01 *et seq.*, "Non-Profit Corporation Code."; NEBRASKA, Chapter 21 Revised Statutes of Nebraska, Sections 21-1901 to 21-1991, "Non-Profit Corporation Act."; NEW MEXICO, Chapter 53 New Mexico Statutes, Section 51-14-20, *et seq.*, "Associations Not-for Profit."; NORTH CAROLINA, Chapter 55A General Statutes of North Carolina, Sections 55A-1 to 55A-80.1, "Non-Profit Corporation Act."; NORTH DAKOTA, Chapter 10-24 North Dakota Century Code, Section 10-24-1 *et seq.*, "Non-Profit Corporation Act."; OHIO, Title 17 Ohio Revised Code Annotated, Sections 1702 *et seq.*, "Non-Profit Corporation Act."; OREGON, Chapter 61 Oregon Revised Statutes, "Non-Profit Corporation Statute"; PENNSYLVANIA, Title 15, Section 2851-1 *et seq.*, "Non-Profit Corporation Law"; VIRGINIA, Title 13 Code of Virginia, §13.1201 *et seq.*, "Virginia Non-Stock Corporation Act."

be placed at serious disadvantage with their stock corporation competitors who, by issuance and sale of shares of stock, can develop capital without incurring income tax liability.

4. The Court of Appeals Erred in Construing and Applying the Applicable Provisions of the Internal Revenue Code.

a. The Court of Appeals Failed to Consider That Petitioner's Members Are Its Owners, and That Proprietary Rights Similar to Those of a Stockholder in a Stock Corporation Vested in Each of Its Members Upon the Tender of a Single Nonrecurring Payment.

Section 1032(a) of the Internal Revenue Code provides as follows:

> "(a) *Non-recognition of gain or loss.* No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.".

In the Tax Court, and in the proceedings in the Court below, petitioner argued that its proprietary memberships exhibited the basic attributes of stock in a stock corporation, and, hence, that the fees paid to petitioner in exchange for its memberships were not subject to tax under the statutory provisions above quoted.

The Court of Appeals, in affirming the Tax Court's judgment (and in overruling the District Court decision in the companion case, *Federal Employees' Distributing Company v. U. S.*) based its decision on a holding that petitioner's "members received in exchange for their fees nothing of substance other than the privilege of buying goods at a discount. . . ." [R. 183.]

In arriving at this holding the Court of Appeals had conceded in its opinion that petitioner's memberships "may, as a matter of form" be "stock" under the commonly given definition quoted by the Court but that nevertheless they were not "stock" as a matter of substance. For, said the Court, "in applying the income tax laws we must regard matters of substance and not mere form."

The error of the Court lies in its failure to observe the precept which it cites. In arriving at its ultimate holding, above summarized, the Court of Appeals ignored the basic fact, uncontested by respondent, that the ownership of petitioner vests wholly and exclusively in its members. The Court below also ignored the uncontested fact that said proprietary rights of the members in and to petitioner arose at the time each member made a single nonrecurring payment to petitioner, at which time the member received a membership certificate. This vesting of ownership is one of the several principal and inseparable rights attaching to memberships in petitioner. This fact of ownership of petitioner by its members is a matter of great substance to petitioner and to its members, collectively and individually. By reason of this ownership, petitioner cannot, without the written consent or approval of at least a majority of its voting membership, be voluntarily wound up and dissolved, or merged or recapitalized.

The decision of the Court below is in basic error in that it rests upon the disregard of a basic and essential matter of substance.

b. The Court of Appeals and the Tax Court Erred by Imparting Subjective Tests Into the Determination of Whether or Not Petitioner's Memberships Were "Stock" Within the Meaning of Section 1032(a).

In the Tax Court and in the court below petitioner urged that the question as to whether its memberships were "stock" within the meaning of Sections 1032(a) and 7701(a)(7) was properly to be answered by the application of a purely objective test: Did petitioner's memberships exhibit the essential characteristics of stock in a stock corporation?

The Tax Court did not reject the objective tests urged by petitioner. Rather, it minimized them and subordinated them to what it deemed was controlling, a subjective test, to wit: Did a member at the time of application for a membership in petitioner consider or intend his membership fee to be a payment "in exchange for stock"? Both the Tax Court and the Court of Appeals concluded that "realistically" petitioner's members could not have viewed their fee payments as payments in exchange for stock or as investments in capital.

Petitioner submits that unless the statutory language clearly requires an examination of intent, motive or purpose,* resort should be had only to objective criteria in the construction and application of the language of our tax law. Petitioner's view is wholly in conformity with the expression of this Court that the will of Congress, as expressed in legislation, "in the absence of language evidencing a different purpose, is

*As in Section 7201, Internal Revenue Code of 1954: "Willfully" attempts to evade or avoid tax; Section 1551, securing of an exemption or credit not a "major purpose" of a transfer to a corporation; Section 269 (a), "Principal purpose . . . for evasion or avoidance" of tax.

to be interpreted so as to give a uniform application to a nationwide scheme of taxation"; *Burnet v. Harmel*, 287 U. S. 103, 110.

Even in the area of stock corporations, under the holding of the Court of Appeals, shareholders might find their shares to be something other than "stock" for federal tax purposes because they were purchased not with an investment intent, but solely or principally with some other purpose in mind, as for example, to satisfy a corporation's requirement that its stock be bought as a prerequisite to the granting to the purchasers of an exclusive license to manufacture its products, or for the "status" aspects of holding a particular stock, or to acquire a privilege coupled with the stock.

Section 1032(a) of the Internal Revenue Code of 1954 speaks in plain language: "the receipt of money . . . in exchange for stock." If the interests acquired by an individual in a stock corporation, nonstock corporation or unincorporated association exhibit, when measured by accepted, objective standards, basic stock characteristics, then they are stock; if they do not, they are not stock. The "intent" or "purpose" of the purchaser in acquiring a proprietary interest in a corporation or association, whether it be for investment purposes, or for the "status" aspects of holding a particular stock, or to acquire a privilege coupled with the stock, is and should be wholly irrelevant to the determination of whether the proprietary interest so acquired exhibits the basic legal rights and relationships characteristic of stock.

The position of petitioner as to the propriety and necessity of interpreting and applying Section 1032 with reference to objective external tests finds strong

support in the opinion of the District Court in *Federal Employees' Distributing Company v. United States of America*, 206 F. Supp. 330 (1963). After reviewing the history of Section 1032, Judge Mathes concludes that the Section should not be construed to require a determination of motive or intent on the part of purchasers of a corporation's stock. Judge Mathes stated at page 336:

> "The nebulous criteria of motive and intent are difficult at best to apply in determining the incidence of any tax; and such criteria should never be resorted to unless their utilization is required by the language or prior construction of the particular statutory term or provision involved, as in the determination of a 'contribution to the capital' under §118."

5. The Court of Appeals Denied Petitioner a Fair Hearing.

Prior to the hearing by the Court of Appeals of the case at bar, the Vanderbilt Law Review published an article devoted exclusively to the case at bar and a companion case now before this court.* The Law Review article was not an exposition on a general legal question, nor was it directed to a broad area of law of interest to the Court of Appeals. To the contrary, it was devoted exclusively to the specific matter pending before the court, *i.e.*, Affiliated Government Employees' Distributing Company vs. Commissioner of Internal Revenue and its companion case. The article purported to review the evidence and develop what its author believed to be appropriate law. There is an important

*Volume 16, Vanderbilt Law Review No. 2, pp. 458-465, attached hereto as Appendix F.

distinction. When considered by a reviewing court, a law review article devoted to the very case and to the specific issues pending before that court is the exact equivalent of an *amicus curiae* brief. It is also a matter wholly outside the record, and a matter upon which petitioner had no opportunity to be heard. Petitioner takes strong exception to the case law cited by the article, as well as its analysis of material facts, and can demonstrate patent error therein. But petitioner has never had this opportunity.

A comparison of the language of the decision of the Court of Appeals with the language contained in the Vanderbilt Law Review article demonstrates unmistakenly that the Court of Appeals, in arriving at its decision, gave consideration to said Law Review article, and indeed quoted in a footnote part of the article in question.** Petitioner submits that the Court of Appeals had no right to consider the Law Review article, or any other document not before the court pertaining to the specific issues in the case at bar, without providing petitioner an opportunity to rebut and challenge the inferences drawn and conclusions reached by such article, or to explain the erroneous premises and law upon which petitioner asserts the Law Review article was predicated.

The consideration by this Court of any matter outside the record, directed to the specific issues before the Court, does violence to long established principles of American jurisprudence. The point is aptly stated by Chief Justice Marshall in *Mitchell v. U. S.*, 33 U. S. 307 (1834):

**322 F. 2d 378, footnote 4, Appendix B, p. 15, *infra*.

"Marshall, Ch.J., said: A pamphlet has been sent to the judges touching the questions in controversy in this cause. The Court desires it to be understood that the practice of the Court is not to receive or examine such papers, unless they have been presented in open court, and shown to opposite counsel.

"It was afterwards, on the same day, stated to the Court by Mr. White, of Florida, counsel for the appellant, that counsel on neither side had any knowledge of the pamphlet having been sent to the Court; nor did they in any manner countenance the same. The pamphlet was sent to the judges by an agent of the appellant, who was not in any manner aware of the irregularity of the proceeding."

The point is also illustrated in *Russell v. Southard*, 53 U. S., 139 at 158 (1851):

"This Court must affirm or reverse upon the case as it appears in the record. We cannot look out of it for testimony to influence the judgment of this Court sitting as an appellate tribunal. And, according to the practice of the Court of Chancery from its earliest history to the present time, no paper not before the Court below, can be read on the hearing of an appeal."

To the same effect are: *Washington Ry. & Electric Co. v. Stuart*, 267 Fed. 632, 644; *Cave v. District of Columbia*, 90 F. 2d 383, 386 (DC Cir. 1937); *Drake v. General Finance Corp. of Louisiana*, 119 F. 2d 588, 589 (5th Cir. 1941); *Haubtman & Loeb Co. v. Hooven-Owens-Rentschler Co.*, 262 Fed. 408 (5th Cir. 1920).

It bears repeating that the Law Review article in question purported to assess the facts and evidence, and to reach certain conclusions on the law in connection with the specific issues before the Court of Appeals. On the face of the record before this Court, the Court of Appeals gave consideration to this article in reaching its decision. No opportunity to respond to the article was given to petitioner. Had petitioner been given its day in court in connection with this article, petitioner could have demonstrated the erroneous assessment of the facts and application of the law contained in the article, and neutralized any effect which might result from its consideration by the Court of Appeals. In the absence of such an opportunity, petitioner was denied its right to a fair hearing and the right to its day in court. The consideration of the article by the Court of Appeals was violative of long established principles of the federal judiciary and was prejudicial to the rights of petitioner herein.

Conclusion.

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

EDWARD L. BUTTERWORTH,
Counsel for Petitioner.

APPENDIX A.

Constitution of the United States

Article 1, Section 2, Clause 3

[cl. 3] *Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding* to the whole Number of free Persons, including those bound to *Service for a Term of Years, and excluding Indians not taxed three fifths of all other Persons.* The actual Enumeration shall be made within three Years after the first Meeting of the Congress of the United States, and within every subsequent Term of ten Years, in such Manner as they shall by Law direct. The Number of Representatives shall not exceed one for every thirty Thousand, but each State shall have at Least one Representative; *and until such enumeration shall be made, the State of New Hampshire shall be entitled to chuse three, Massachusetts eight, Rhode-Island and Providence Plantations one, Connecticut five, New-York six, New Jersey four, Pennsylvania eight, Delaware one, Maryland six, Virginia ten, North Carolina five, South Carolina five, and Georgia three.*

Article 1, Section 9, Clause 4

[cl. 4] No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

Sixteenth Amendment

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or Enumeration.

Italics indicate matter superseded or modified by amendment, or by the elapse of time.

Statutes

Internal Revenue Code of 1954

SEC. 61 GROSS INCOME DEFINED.

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items; . . .

SEC. 1032. EXCHANGE OF STOCK FOR PROPERTY.

(a) Nonrecognition of Gain or Loss.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * * *

(3) Corporation.—The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * * * * * *

(7) Stock.—The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) Shareholder.—The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

APPENDIX B.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Affiliated Government Employees' Distributing Company, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. No. 17,985 Sept. 16, 1963.

On Petition to Review a Decision of the Tax Court of the United States.

Before: Orr, Hamlin and Duniway, Circuit Judges

Hamlin, Circuit Judge.

This is a petition for review of a decision of the Tax Court (37 T.C. 909) and involves tax deficiencies determined and assessed by respondent against Affiliated Government Employees' Distributing Company (hereafter petitioner) for its taxable years ended June 30, 1956, and June 30, 1957. We have jurisdiction under sections 7482 and 7483 of the Internal Revenue Code to review the decision of the Tax Court.

Petitioner operates a group of department stores in the San Francisco Bay area for the exclusive use of its members and guests. The issue before the Tax Court was whether the membership fees paid to petitioner could be considered exempt from taxation either as contributions to capital under section 118 of the Internal Revenue Code of 1954 or as money received in exchange for stock under section 1032 of the Code. Petitioner now concedes that the fees could not be considered contributions to capital, but contends that the Tax Court erred in failing to find that the fees were paid in exchange for stock.

The facts are not in dispute and for the purpose of this opinion we will adopt the following findings of the Tax Court:

"Petitioner, a so-called nonprofit membership corporation, was organized in 1953 and exists pursuant to the General Non-Profit Corporation Law of the State of California. * * *

"Petitioner is a retail merchandising corporation which sells a broad line of consumer goods. It does not sell to the public at large but restricts its sales and the use of its premises and facilities to its members and their guests. Members are admitted to petitioner's stores only upon presentation of a membership card and upon signing a register. However, guests are admitted when accompanied by members and may thus make purchases without restriction.

"Prior to July 23, 1956, petitioner had two classes of membership: regular and honorary. Regular memberships were issuable to any active or retired employee of the Federal, state, or local government for an 'initiation fee' of two dollars. Such memberships were for the life of the member and were nontransferable and nonassessable. Honorary memberships required no initiation fee and were issuable to any person at the discretion of petitioner's board of directors, but not in excess of five per calendar year. On June 30, 1956, petitioner had 77,991 regular members and less than ten honorary members.

"Under petitioner's by-laws in effect prior to July 23, 1956, both regular and honorary members possessed the right to vote for its board of di-

rectors and on other corporate matters. Any membership could be revoked by two-thirds vote of the board of directors 'for cause,' and the membership fee paid was not refundable. Any member could resign his membership and be refunded his membership fee. In the fiscal year ended June 30, 1956, a total of 52 members either resigned or had their membership revoked. All such members (including the revoked memberships, contrary to the by-laws) had their membership fees refunded.

"On and subsequent to July 23, 1956, when petitioners by-laws were revised, petitioner had three classes of membership: life, associate (Class 1 and Class 2), and honorary. Life memberships were the counterpart of the earlier regular memberships, issuable to any active or retired employee of the Federal, state, or local government for a "consideration" of two dollars. Associate memberships, Class 1, were issuable to the widows of government employees, were for life, and cost two dollars; associate memberships, Class 2, were issuable to any person who had served at least six months in the Armed Forces of the United States, were also for life, and cost three dollars. Honorary memberships were issuable without cost to any person at the discretion of petitioner's board of directors, but not in excess of fifteen per calendar year. At the dates indicated, the number of members in each class was as follows:

	December 31, 1956	June 30, 1957
Life members	90,950	98,107
Associate members	10,278	16,322
Honorary members	Less than 10	Less than 10

"Under the revised by-laws, only life members were entitled to vote and to attend annual or special membership meetings. In the event of petitioner's liquidation or dissolution or winding up, both life and associate members were to be entitled to a distribution pro rata of any assets remaining to be distributed among or paid over to the members. All classifications of membership were non-transferable and non-assessable. Any membership could be revoked by a two-thirds vote of petitioner's board of directors 'for any cause deemed sufficient' by the board without refunding any consideration paid. Any member could resign his membership and be refunded his membership fee. In the event of the death of a life or associate member, the consideration paid for his membership was payable to the member's estate upon request of his executor or administrator.

"On November 17, 1956, petitioner's by-laws were amended to provide that thereafter all refunding of membership fees, whether based on revocation, resignation, or death of the member, would be within the sole discretion of its board of directors.

"In the fiscal year ended June 30, 1957, a total of 57 members either resigned or had their membership revoked. All such members (including those whose memberships were revoked, contrary to the by-laws until November 17, 1956) had their membership fees refunded.

"Revocation of membership in petitioner during the taxable years in issue was based on action by the member contrary to the interests of petitioner.

Such action included cashing bad checks, shoplifting, and in a single case using the membership privileges for the purpose of obtaining information for use against petitioner in a fair trade pricing dispute.

"Prior to issuance of memberships to eligible persons, petitioner has at all times since its incorporation filed applications for authorizing permits with the Division of Corporations of the Department of Investments of the State of California and has obtained responsive permits from the Commissioner of Corporations of the State of California authorizing the issuance and sale of such memberships as 'securities.' No memberships have been sold by petitioner except pursuant to authorizing permit of the Commissioner of Corporations.

"Eligible persons apply for membership either in person at one of petitioner's stores or by mail. Each is required to furnish proof of qualification, as well as to fill out and subscribe his or her name to an application card. During the years here in issue the application for life (regular) membership contained the following information about petitioner:

> A.G.E. (Affiliated Government Employees) is a California Non-Profit corporation, not privately owned, but belongs to the membership and is managed and operated by a Board of Directors, the majority being members and Government employees.
>
> A.G.E. considers as eligible, any Full Time Employee of a city, county, state, military, or Federal government, or receiving retirement pay

from same, members of organized reserve of U. S. Armed Forces and National Guard units. Lifetime Membership $2.00. Non-Assessable. Non-Transferable.

* * * * *

A.G.E. is a buying (not selling) organization for its members. Its purpose is to obtain merchandise and services at the lowest prices obtainable, and operating on a cost plus basis to cover overhead of operations.

* * * * *

"The receptionist who examines applicants' identification and assists them in filling out the required application card does not instruct applicants on the rights and privileges of membership.

"Those who apply in person for life memberships (called regular memberships prior to July 23, 1956) are also requested, though not required, to execute proxies to petitioner's management. Generally, the members who applied by mail did not execute proxies. The number of members entitled to vote and the number of proxies filed by such members were as follows at the dates indicated:

	Number of Members Entitled to Vote	Proxies Filed
June 30, 1956	77,991	49,020
June 30, 1957	98,107	66,833

"Memberships in petitioner are represented only by small cards suitable for insertion in a wallet. The main function of such cards is to identify the holder as a member in order that he may be admitted to petitioner's premises.

"All of petitioner's members, regardless of classification, are entitled to the following membership privileges:

(a) They are privileged to enter into any of petitioner's store premises and to inspect the merchandise on display.

(b) They are privileged to purchase merchandise at prices fixed by petitioner.

(c) In certain cases and in respect of certain items of goods or merchandise not stocked by petitioner, members are referred to other stores or establishments where, under prior arrangements made by petitioner, its members are privileged to purchase such items at prices fixed by such stores or establishment.

(d) They receive the A.G.E. Reporter, a pamphlet published monthly by petitioner which informs its members of petitioner's current sales events.

"In addition, any member is permitted to bring guests and guests are permitted to make purchases in petitioner's stores at the same prices that members pay.

"Petitioner has at all times classified membership fees in a capital account on its books and records and in its balance sheets.

"At no time has petitioner charged or required payment of its members in respect of renewal fees, dues, or other periodic charges, nor has petitioner received from its members any such fees, dues, or other periodic charges. Memberships in petitioner do not expire or require renewal at fixed intervals.

"At no time has petitioner paid dividends or otherwise made distributions of surplus to its members. Its Articles of Incorporation and the General Non-Profit Corporation Law of the State of California under which petitioner was formed prohibit the distribution of gains, profits, or dividends to its members and likewise prohibit the distribution of assets to its members except on dissolution or winding up.

"During the fiscal years ending June 30, 1954 through June 30, 1957, petitioner's annual, non-profits [sic] (not including such fees) after payment of income taxes were as follows:

	June 30, 1954	June 30, 1955	June 30, 1956	June 30, 1957
Membership Fees	$27,341	$73,271	$51,382	$ 89,186
After Tax Profits	10,213	50,378	91,259	171,625

"Petitioner's accumulated earned surplus as of June 30, 1956 was $149,968 according to its book of account. As of June 30, 1957, it was $321,597.

"An annual meeting of petitioner's members was regularly held pursuant to its by-laws. Typewritten notice of such meetings was posted on a bulletin board adjacent to the sole entrance to each store at least fifteen days prior to the meetings. This was the only notice of the annual meetings during the taxable years in issue; however, in recent years notices have also been published in the A.G.E. Reporter which is sent to each of petitioner's members.

"During the fiscal years ending June 30, 1954 through June 30, 1958, meetings of petitioner's members entitled to vote were held on the dates

and with members attending, in person or by proxy, as follows:

Date	Attendance By Proxy	In Person
May 17, 1954	3,291	4
July 14, 1955	33,154	Less than 25
July 23, 1956	49,020	Less than 25
July 22, 1957	66,833	Less than 25"

During the years in question, petitioner leased the premises in which its business was carried on.[1]

The Tax Court concluded that the membership fees "were plainly of a type of receipt that is normally regarded as income" and then considered whether the fees fell within the exclusionary provisions of section 118 of the Code (relating to contributions to capital) or section 1032 (relating to a corporation's receipt of money or property in exchange for its stock). The Court held that the fees "were paid predominantly for the privilege of shopping at petitioner's stores and using its facilities" and as such were not exempt under either statute. As noted earlier, petitioner now concedes that the fees would not be considered contributions to capital, but contends that the Tax Court erred in failing to hold that they were paid in exchange for stock. For the reasons to be discussed hereafter, we agree with the Tax Court.

Section 1032 of the Internal Revenue Code of 1954 provides in pertinent part as follows:

> "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."

---

[1] Additional findings were made by the Tax Court concerning the salaries paid to employees and officers of petitioner and the profit sharing trust which had been set up for them.

Although none of the prior revenue acts had contained a similar provision it was clear even before the enactment of section 1032 that no gain or loss was realized by a corporation on the original sale of its stock. Difficulties arose, however, in determining whether gain or loss was realized by a corporation when it disposed of its treasury stock. To clarify the situation, section 1032 was enacted to provide for the non-recognition of gain or loss whenever a corporation receives money or property for its stock. Thus, generally speaking, Congress was only concerned with the problem of taxing gains or losses on treasury stock transactions and did not consider the problems which might arise in defining the term "stock."[2]

The term "stock" is not in fact specifically defined in the Code. Section 7701(a) (7) does provide that the term "includes shares in an association, joint-stock company, or insurance company." It would appear therefore that Congress chose to accept the ordinary connotations of the term and merely listed certain interests which might not be considered "stock", as it is normally defined. For the purpose of this opinion, we shall accept the following commonly given definition of stock quoted in petitioner's brief:

> ". . . the interest or right which the owner, who is called the 'shareholder' or 'stockholder' has in the management of the corporation, and in its surplus profits, and, on a dissolution in all of its assets remaining after the payments of its debts."

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[2]See Mertens, Law of Federal Income Taxation, Code Commentary, sec. 1032 for a detailed discussion of the legislative history and purpose of section 1032; see also Mertens, *supra*, volume 7, sec. 38.29.

The fact that memberships in petitioner may, as a matter of form, fall within the purview of this definition does not, of course, control, since in applying the income tax laws we must regard matters of substance and not mere form.[3]

Analysis of the substance of the relationship between petitioner and its members reveals to us that the fees in the instant case were not received by petitioner in exchange for its stock, but rather were received for the privilege of buying goods at a discount at petitioner's stores. Although the memberships technically had some of the indicia of stock, *i.e.*, the right to vote for the management and the right to share in the assets upon dissolution of the corporation, these facts must be considered in the following context: a merchant-customer relationship existed between petitioner and its members; the fee paid for the privilege of purchasing at the stores was small, members did not share in profits or potential growth of the corporation during its life; membership was not assignable and terminated at death; memberships were subject to revocation for any cause deemed sufficient; refunds of the fee either upon death or resignation were solely within the discretion of the Board of Directors; and no certificate of membership other than a wallet-sized card was issued. Neither does it appear that a conscientious effort was made to inform the members of their rights to vote and share in the assets of the corporation upon liquidation. The applicants were not told at the time of their applications that they had these rights and the rights were not listed on the membership cards. Even assum-

[3]See Weiss v. Stearn, 265 U.S. 242, 254 (1924).

ing that a substantial number of the members knew of their right to vote, we submit that on the basis of the facts outlined above it could not have been reasonably foreseen that the average member would have any desire to exercise the right; it is also difficult to believe, as stated by the Tax Court, "that the remote possibility of participating in any . . . distribution upon liquidation was a factor of any consequence in relation to the payment of the comparatively small fees here in issue."

Further, as noted earlier, the Tax Court emphasized the fact that the fees "were paid predominantly for the privilege of shopping at petitioner's stores and using its facilities." Petitioner contends that motive or intent of the purchaser has no relevance to the determination whether "stock" has been purchased. If no question were raised as to the substance of the interests or rights which allegedly qualified the members as "stockholders," we would be inclined to agree with petitioner. Here, however, we feel that the issue is whether the members received any interest of substance in the corporation other than the privilege to buy at discount. In resolving this issue, we feel that the Tax Court was justified in considering all of the circumstances surrounding the purchase of memberships, including the motives or purposes of the parties to the transaction. In the instant case, we cannot see how either the management or the applicants could realistically have considered the fees paid to have been "in exchange for stock."

We do not hold here that memberships in non stock corporations cannot fall within the purview of section 1032; nor do we hold that the absence of one or more of the normal indicia of stock considered above

would preclude an exclusion under the statute. We merely hold on the facts of this case that the members received in exchange for their fees nothing of substance other than the privilege of buying goods at a discount, that their fees were thus paid solely for direct benefits to be received from petitioner[4] and as such constituted taxable income to petitioner.[5]

The judgment of the Tax Court is affirmed.

(Endorsed) Opinion Filed September 16, 1963.

Frank H. Schmid, Clerk.

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[4]Cf., Community T. V. Association of Havre v. United States, 203 F. Supp. 270 (D.C. Montana 1962). See also 16 Vanderbilt Law Review 458, 465 (1963), in which the position is taken that "[T]axation of the receipts from the sale of membership certificates will not appreciably affect discount selling, whereas a non-taxable status to these receipts will be an impetus to discount sellers to utilize comparable customers selection arrangements which offer them a windfall tax benefit."

[5]The record reveals that in the exercise of its discretion the Board has refunded a small number of membership fees. When such refunds are made it would seem appropriate that a tax adjustment be made. This problem, however, is not currently before us.

APPENDIX C.

37 T. C. No. 88

Tax Court of the United States

AFFILIATED GOVERNMENT EMPLOYEES DISTRIBUTING COMPANY, a corporation, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 84190

Filed February 12, 1962

FINDINGS OF FACT AND OPINION

Petitioner, a California nonstock membership corporation, operates a group of department stores in the San Francisco Bay area for the exclusive use of its members and their guests. Membership is not open to the public but is restricted to active and retired government employees and widows of such government employees for a fee of two dollars and to veterans for a fee of three dollars. Membership is for life, terminates automatically upon death, is nontransferable and nonassessable, and is represented by a wallet-sized pass card which is used to identify the holder for admittance to petitioner's stores. Held that the membership fees received by petitioner during its fiscal years ending June 30, 1956 and 1957 were paid predominantly for the privilege of shopping at petitioner's stores and constituted taxable income; they were not exempt either as capital contributions or as money received in exchange for stock under Sections 118 and 1032 of the 1954 Code.

Charles J. Leighton, Jr., Esq., and Edward L. Butterworth, Esq., for the petitioner.

John O. Hargrove, Esq., for the respondent.

Respondent determined deficiencies in petitioner's income tax for the fiscal year ended June 30, 1956 in the

amount of $20,718.64 and for the fiscal year ended June 30, 1957 in the amount of $46,188.48.

The sole issue is whether so-called membership fees received by petitioner from its new members during the fiscal years ended June 30, 1956 and June 30, 1957 constitute taxable income.

Findings of Fact

The facts stipulated by the parties are hereby incorporated by this reference.

Petitioner, a so-called nonprofit membership corporation, was organized in 1953 and exists pursuant to the General Non-Profit Corporation Law of the State of California. Its principal office is located at 400 Hegenberger Road, Oakland, Alameda County, California. Petitioner's income tax returns for the fiscal years ending June 30, 1956 and June 30, 1957 were filed with the district director of internal revenue, San Francisco, California.

Petitioner is a retail merchandising corporation which sells a broad line of consumer goods. It does not sell to the public at large but restricts its sales and the use of its premises and facilities to its members and their guests. Members are admitted to petitioner's stores only upon presentation of a membership card and upon signing a register. However, guests are admitted when accompanied by members, and may thus make purchases without restriction.

Prior to July 23, 1956, petitioner had two classes of membership: regular and honorary. Regular memberships were issuable to any active or retired employee of the Federal, state, or local government for an "initiation fee" of two dollars. Such memberships were

for the life of the member and were nontransferable and nonassessable. Honorary memberships required no initiation fee and were issuable to any person at the discretion of petitioner's board of directors, but not in excess of five per calendar year. On June 30, 1956, petitioner had 77,991 regular members and less than ten honorary members.

Under petitioner's by-laws in effect prior to July 23, 1956, both regular and honorary members possessed the right to vote for its board of directors and on other corporate matters. Any membership could be revoked by a two-thirds vote of the board of directors "for cause," and the membership fee paid was not refundable. Any member could resign his membership and be refunded his membership fee. In the fiscal year ended June 30, 1956, a total of 52 members either resigned or had their membership revoked. All such members (including the revoked memberships, contrary to the by-laws) had their membership fees refunded.

On and subsequent to July 23, 1956, when petitioner's by-laws were revised, petitioner had three classes of membership: life, associate (Class 1 and Class 2), and honorary. Life memberships were the counterpart of the earlier regular memberships, issuable to any active or retired employee of the Federal, state, or local government for a "consideration" of two dollars. Associate memberships, Class 1, were issuable to the widows of government employees, were for life, and cost two dollars; associate memberships, Class 2, were issuable to any person who had served at least six months in the Armed Forces of the United States, were also for life, and cost three dollars. Honorary memberships were issuable without cost to any person at the discretion of

petitioner's board of directors, but not in excess of fifteen per calendar year. At the dates indicated, the number of members in each class was as follows:

	December 31, 1956	June 30, 1957
Life members	90,950	98,107
Associate members	10,278	16,322
Honorary members	Less than 10	Less than 10

Under the revised by-laws only life members were entitled to vote and to attend annual or special membership meetings. In the event of petitioner's liquidation or dissolution or winding up, both life and associate members were to be entitled to a distribution pro rata of any assets remaining to be distributed among or paid over to the members. All classifications of membership were nontransferable and nonassessable. Any membership could be revoked by a two-thirds vote of petitioner's board of directors "for any cause deemed sufficient" by the board without refunding any consideration paid. Any member could resign his membership and be refunded his membership fee. In the event of the death of a life or associate member, the consideration paid for his membership was payable to the member's estate upon request of his executor or administrator.

On November 17, 1956, petitioner's by-laws were amended to provide that thereafter all refunding of membership fees, whether based on revocation, resignation, or death of the member, would be within the sole discretion of its board of directors.

In the fiscal year ended June 30, 1957, a total of 57 members either resigned or had their membership revoked. All such members (including those whose

memberships were revoked, contrary to the by-laws until November 17, 1956) had their membership fees refunded.

Revocation of membership in petitioner during the taxable years in issue was based on action by the member contrary to the interests of petitioner. Such action included cashing bad checks, shoplifting, and in a single case using the membership privilege for the purpose of obtaining information for use against petitioner in a fair trade pricing dispute.

Prior to issuance of memberships to eligible persons, petitioner has at all times since its incorporation filed applications for authorizing permits with the Division of Corporations of the Department of Investments of the State of California and has obtained responsive permits from the Commissioner of Corporations of the State of California authorizing the issuance and sale of such memberships as "securities." No memberships have been sold by petitioner except pursuant to authorizing permit of the Commissioner of Corporations.

Eligible persons apply for membership either in person at one of petitioner's stores or by mail. Each is required to furnish proof of qualification, as well as to fill out and subscribe his or her name to an application card. During the years here in issue the application for life (regular) membership contained the following information about petitioner:

> A.G.E. (Affiliated Government Employees) is a California Non-Profit corporation, not privately owned, but belongs to the membership and is managed and operated by a Board of Directors, the majority being members and Government employees.

A.G.E. considers as eligible, any Full Time Employee of a city, county, state, military, or Federal government, or receiving retirement pay from same, members of organized reserve of U. S. Armed Forces and National Guard units. Lifetime Membership $2.00. Non-Assessable. Non-Transferable.

* * * * *

A.G.E. is a buying (not selling) organization for its members. Its purpose is to obtain merchandise and services at the lowest prices obtainable, and operating on a cost plus basis to cover overhead of operations.

* * * * *

The receptionist who examines applicants' identification and assists them in filling out the required application card does not instruct applicants on the rights and privileges of membership.

Those who apply in person for life memberships (called regular memberships prior to July 23, 1956) are also requested, though not required, to execute proxies to petitioner's management. Generally, the members who applied by mail did not execute proxies. The number of members entitled to vote and the number of proxies filed by such members were as follows at the dates indicated:

	Number of Members Entitled to Vote	Proxies Filed
June 30, 1956	77,991	49,020
June 30, 1957	98,107	66,833

Memberships in petitioner are represented only by small cards suitable for insertion in a wallet. The main function of such cards is to identify the holder

as a member in order that he may be admitted to petitioner's premises.

All of petitioner's members, regardless of classification, are entitled to the following membership privileges:

(a) They are privileged to enter into any of petitioner's store premises and to inspect the merchandise on display.

(b) They are privileged to purchase merchandise at prices fixed by petitioner.

(c) In certain cases and in respect of certain items of goods or merchandise not stocked by petitioner, members are referred to other stores or establishments where, under prior arrangements made by petitioner, its members are privileged to purchase such items at prices fixed by such stores or establishments.

(d) They receive the A.G.E. Reporter, a pamphlet published monthly by petitioner which informs its members of petitioner's current sales events.

In addition, any member is permitted to bring guests and guests are permitted to make purchases in petitioner's stores at the same prices that members pay.

Petitioner has at all times classified membership fees in a capital account on its books and records and in its balance sheets.

At no time has petitioner charged or required payment of its members in respect of renewal fees, dues, or other periodic charges, nor has petitioner received from its members any such fees, dues, or other pe-

riodic charges. Memberships in petitioner do not expire or require renewal at fixed intervals.

At no time has petitioner paid dividends or otherwise made distributions of surplus to its members. Its Articles of Incorporation and the General Non-Profit Corporation Law of the State of California under which petitioner was formed prohibit the distribution of gains, profits, or dividends to its members and likewise prohibit the distribution of assets to its members except on dissolution or winding up.

During the fiscal years ending June 30, 1954 through June 30, 1957, petitioner's annual, nonprofits (not including such fees) after payment of income taxes were as follows:

	June 30, 1954	June 30, 1955	June 30, 1956	June 30, 1957
Membership Fees	$27,341	$73,271	$51,382	$ 89,186
After Tax Profits	10,213	50,378	91,259	171,625

Petitioner's accumulated earned surplus as of June 30, 1956 was $149,968 according to its book of account. As of June 30, 1957, it was $321,597.

An annual meeting of petitioner's members was regularly held pursuant to its by-laws. Typewritten notice of such meetings was posted on a bulletin board adjacent to the sole entrance to each store at least fifteen days prior to the meetings. This was the only notice of the annual meetings during the taxable years in issue; however, in recent years notices have also been published in the A.G.E. Reporter which is sent to each of petitioner's members.

During the fiscal years ending June 30, 1954 through June 30, 1958, meetings of petitioner's members entitled to vote were held on the dates and with members attending, in person or by proxy, as follows:

Date	Attendance	
	By Proxy	In Person
May 17, 1954	3,291	4
July 14, 1955	33,154	Less than 25
July 23, 1956	49,020	Less than 25
July 22, 1957	66,833	Less than 25

During the years ending June 30, 1956 and June 30, 1957, petitioner carried on its business in store and warehouse premises at the following locations: 6625 Foothill Boulevard, Oakland, California, (until November 1955 when petitioner moved to its Hegenberger Road premises); 400 Hegenberger Road, Oakland, California, (subsequent to November 1955); 124 Highway 40, Vallejo, California; 3330 Telegraph Avenue, Oakland, California. During these years, petitioner's occupancy of the premises at each of the above locations was as lessee under leases with various lessors.

The major portion of petitioner's main store and headquarters at 400 Hegenberger Road, Oakland, California, was leased under three separate leases from a stock corporation called A.P.C., Inc., which was organized on November 29, 1954, for the purpose among others of building and leasing the above-mentioned property to petitioner. At June 30, 1956 and June 30, 1957, there were 1,199.95 shares of A.P.C., Inc. stock issued and outstanding. At both dates these shares were held as follows: an aggregate of 294 (or 24.5 percent) of the total was held by petitioner, its officers,

and directors; an aggregate of 819.95 (or 68.3 percent) of the shares was held by concessionaires, employees and suppliers of petitioner or by relatives of such concessionaires, employees and suppliers; an aggregate of 86 (or 7.2 percent) of the shares was held by shareholders who had no business relationship with petitioner or with petitioner's concessionaires or suppliers.

Petitioner's warehouse adjacent to its main store and its premises at its other three locations listed above were leased from lessors other than A.P.C., Inc.; none of these other lessors had any relation, direct or indirect, to petitioner other than that of lessor to lessee.

Petitioner's officers and directors and their respective salaries during the fiscal years ending June 30, 1954, through June 30, 1957, were as follows:

Name	Position (1954-1957)	Salary 1954	1955	1956	1957
Harvey C. Binns	Board Chairman and Treasurer	$9,525	$45,285	$39,710	$82,936
O. C. Reirsgaard	Secretary and Director	8,400	27,687	39,613	33,705
P. B. Godkin*	President and Director	1,156	2,730	5,960	9,726
J. W. Lance*	Vice President and Director	1,056	3,979	5,960	8,670
I. D. Thompson*	Vice President and Director	1,106	2,730	5,960	7,140

*Not full time during entire period

None of petitioner's officers and directors were related by blood or marriage to one another. Petitioner's board of directors met regularly and not less than twice each month during the taxable years in issue.

Harvey C. Binns, in addition to being board chairman and petitioner's treasurer, was general manager of petitioner. He was in charge of petitioner's day-to-day operations. He was the moving force in organizing petitioner in 1953 and has dominated its affairs since

that time, at least through the taxable years. It does not appear that Binns was a member of petitioner until May 17, 1954, when he and Orville C. Reiersgaard were made honorary members, no other honorary memberships having been issued up to that time. He was petitioner's highest paid officer and, as hereinafter indicated, petitioner's contributions on his behalf to a profit sharing trust substantially exceeded its similar contributions on behalf of any other officer or employee. On April 13, 1957, he received a $25,000 personal loan from petitioner.

Petitioner carried life insurance policies on its officers during the years in issue, paid the premiums on such policies, and was the designated beneficiary thereunder. Since the years in question, some of these policies have been sold by petitioner to the insured officers for their cash value.

Petitioner has a profit-sharing trust in existence for the benefit of its officers and employees to which it contributed $46,279.10 in the fiscal year ended June 30, 1956, and $66,961.84 in the fiscal year ended June 30, 1957. Petitioner's contributions to this trust in respect of its two highest paid officers, Harvey C. Binns and O. C. Reiersgaard, during these two years were as follows:

	1956	1957
Harvey C. Binns	$8,956.63	$12,440.44
O. C. Reiersgaard	2,770.89	3,555.75

Contributions in respect of all other employees or officers were in smaller amounts. Petitioner's members are not participants in the profit-sharing trust. The

trust lent A.P.C., Inc. $50,000 on April 30, 1957, for the purpose of building a restaurant adjacent to petitioner's main store. Petitioner has no direct interest in the restaurant, called "The House of Harvey," but Harvey C. Binns (after whom the restaurant was named) is a stockholder in the corporation which operates the restaurant.

During the fiscal year ending June 30, 1956, petitioner maintained an average inventory of $346,000 which it turned over 9.71 times in the course of the year. In the fiscal year ending June 30, 1957, it maintained an average inventory of $557,000 which was turned over 7.81 times.

The sales at petitioner's stores are made both by petitioner and by concessionaires operating on petitioner's premises. During the fiscal year ending June 30, 1956, petitioner made about 60 percent of the gross sales and 40 percent was made by concessionaires. During the fiscal year ending June 30, 1957, petitioner made about 54 percent of such sales and concessionaires made 46 percent.

Concessionaires are independent operators who occupy generally the position of tenants and conduct their merchandising business within the physical confines of petitioner's premises. Concessions are utilized for specialized merchandise in cases where a concessionaire can operate more efficiently than petitioner. Concessionaires own their own inventory and hire their own sales personnel. Their rent or concession fee is payable to petitioner and is based on a percentage of sales (approximately six percent in the years in issue); their tenancy may be terminated by petitioner at any time.

Neither petitioner nor any of its officers or directors, either directly or indirectly, have any financial interest in any concession.

During the years in issue petitioner had a wholly-owned subsidiary, Selmor Company, which was created primarily for the purpose of obtaining merchandise for petitioner from certain manufacturers and suppliers which, due to petitioner's pricing policies, did not want to sell directly to petitioner.

The deficiency notice sent to petitioner explained the adjustments made by respondent as follows:

> It is determined that you realized income from membership fees in the amount of $51,382.00 during the taxable year ended June 30, 1956, and in the amount of $88,824.00 during the taxable year ended June 30, 1957, which amounts were credited to a capital account on your records, and excluded from taxable income.

Opinion

Raum, Judge: Petitioner is a nonstock, membership corporation which during the taxable years in issue operated three department stores in the San Francisco Bay area. Only petitioner's members and their guests were allowed to shop at these stores, which sold a broad line of goods and services purportedly at reduced prices. Membership in petitioner was not open to the public; it was restricted to active and retired Government employees (Federal, state and municipal) and, beginning in the second taxable year before us, veterans and widows of Government employees. Memberships were for the life of the applicant, were issued for a fee of two dollars (Government employees and

their widows) or three dollars (veterans), and were nontransferable and nonassessable. The question before us is whether such fees, in the aggregate amounts of $51,382 and $88,824,[1] for petitioner's fiscal years 1956 and 1957, respectively, are taxable as income. We hold that they are.

It is important to note preliminarily that although petitioner may be labeled as a "non-profit" corporation in California, it is not in fact a nonprofit corporation. Indeed, such is petitioner's contention, as set forth in its brief:

> Petitioner's is a business and operation of general retail merchandising for profit, substantial profit. The most casual glance at petitioner's balance sheets and income statements discloses profits, retained earnings and an annual rate of return on equity invested capital (memberships) which would be the envy of many conventional, profit seeking corporations.

Accordingly, it is undisputed that petitioner itself is not exempt and that it is a taxable corporation under the Federal statute. The only matter in controversy is whether the so-called membership fees must be included in its gross income.

At the outset, it must be remembered that in using the term "gross income" Congress has legislated so as to exercise its power within the full reach of its authority under the Constitution. As was stated in Com-

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[1] This is the amount upon which the deficiency for 1957 was based. However, the stipulation of facts shows that the fees for that year were in the amount of $89,180; the difference remains unexplained.

missioner v. Glenshaw Glass Co., 348 U. S. 426, 429, 430:

> This Court has frequently stated that this language was used by Congress to exert in this field "the full measure of its taxing power." [Citing cases] * * * And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. [Citing cases.] * * *

The so-called membership fees herein were plainly of a type of receipt that is regarded as taxable income. Cf. Teleservice Company of Wyoming Valley, 27 T.C. 722, affirmed, 254 F. 2d 105 (C. A. 3), certiorari denied, 357 U. S. 919; Keystone Automobile Club, 12 T. C. 1038, affirmed, 181 F. 2d 402, 405 (C. A. 3); Chattanooga Automobile Club, 12 T. C. 967, affirmed, 182 F. 2d 551 (C. A. 6); Automobile Club of Michigan, 20 T. C. 1033, affirmed, 230 F. 2d 585 (C. A. 6), affirmed, 353 U. S. 180; American Automobile Association v. United States, 367 U. S. 687; Automobile Club of N. Y. Inc., 32 T. C. 906; United Grocers, Ltd. v. United States, 186 F. Supp. 724 (N. D. Cal.), amended, ... F. Supp. ....; United Retail Grocers Association, 19 B. T. A. 1016; Jockey Club, 30 B. T. A. 670, affirmed, 76 F. 2d 597 (C. A. 2). Petitioner contends, however, that its fees are exempt as "contribution[s] to * * * [its] capital" under Section 118 of the 1954 Code[2] or as money received "in exchange for [its] stock" under Section

[2]Sec. 118. Contributions to the Capital of a Corporation.
(a) General Rule.—In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer.

1032(a).[3] We think neither of these provisions "specifically exempt[s]" (Glenshaw Glass, supra) the so-called membership fees before us.

The mere fact that petitioner is theoretically a membership corporation or that its memberships may be designated as "securities" under California law for certain purposes is not determinative of the issue under the Federal statute. The important consideration relates more to the real nature of these fees than to the theoretical status of the members. We are satisfied that the dominant if not the only purpose for which members "joined" petitioner and paid the requisite fee was to be permitted to shop at petitioner's stores where they expected to obtain bargains. While it is true, as petitioner insists, that the members (or some classes of members) had a right to elect the board of directors and to share in the distribution of assets upon liquidation, these appear to be exceedingly minor considerations when examined in proper context.

The two or three dollar fee, though substantial in the aggregate to petitioner, was comparatively small to the individual. Members were not entitled to share in the profits of the enterprise nor to receive distributions of any kind during the life of petitioner. And since memberships were not assignable and terminated with death of the individual, neither the member nor his estate was assured of any share in a possible future dis-

[3] Sec. 1032. Exchange of Stock for Property.

(a) Nonrecognition of Gain or Loss.—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

* * * * *

tribution upon liquidation. It is difficult for us to believe that the remote possibility of participating in any such distribution upon liquidation was a factor of any consequence in relation to the payment of the comparatively small fees here in issue. Moreover, memberships were subject to revocation by the board of directors "for cause" prior to July 23, 1956, and "for any cause deemed sufficient" by the board thereafter. No certificates of membership were issued other than a wallet-sized card which in substance was little more than a pass to gain admittance to petitioner's stores. Although petitioner's by-laws granted the right to vote for the board of directors to all of its members (regular and honorary) prior to July 23, 1956, and to only one class (life) thereafter, such right in practice was more theoretical than real. It seems clear on this record that petitioner was organized, controlled by, and to a certain extent operated for the benefit of, a small group of men, particularly Harvey Binns (a non-duespaying "honorary member"), and that a realistic appraisal of all the facts could hardly justify treating the members as stockholders who had invested their capital in petitioner.

We do not suggest that the membership fees were utterly lacking in any indicia of capital. But it does seem plain to us that they were paid predominantly for the privilege of shopping at petitioner's stores and using its facilities. As such they were not exempt under either Section 118 or Section 1032. They were not a "contribution to the capital of the taxpayer" (Section 118) and they certainly were not paid "in exchange for stock" (Section 1032).

What was said by the Court of Appeals for the Third Circuit in a somewhat different context in Teleservice Company of Wyoming Valley v. Commissioner, supra, 254 F. 2d 105, 112, affirming 27 T.C. 722, is also pertinent to any candid consideration of petitioner's membership fees:

> Analysis of the substance rather than the semblance of the relationship existing between the taxpayer and its customers in the light of the principle that "taxation is an intensely practical matter" inescapably discloses that the relationship was that of seller-customer * * * The initial payment made by a customer was the admission price which he paid for his individual enjoyment of the taxpayer's facilities and in no sense could it be regarded as a contribution to a community participation. Only he who bought a ticket could "go for the ride."

In the instant case, only he who purchased a membership card could have the opportunity to shop for bargains, real or fancied, at petitioner's department stores. We hold that the respondent correctly determined that the receipt of membership fees by petitioner constituted taxable income.

Decision will be entered for the respondent.

Served February 12, 1962.

APPENDIX D.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

United States of America, Appellant, vs. Federal Employees' Distributing Company, Appellee. No. 18,321 Sept. 16, 1963.

On Appeal from the Judgment of the United States District Court for the Southern District of California.

Before: Orr, Hamlin and Duniway, Circuit Judges.

Hamlin, Circuit Judge.

This action involves federal income taxes and statutory interest for the period July 1, 1956, to December 31, 1956, in the amount of $46,171.47 and for the calendar year 1957 in the amount of $107,583.94. The United States District Court for the Southern District of California awarded a judgment in favor of the taxpayer[1] and the government has appealed therefrom.

Federal Employees' Distributing Company (appellee herein), a California non-stock membership corporation which issues memberships chiefly to government employees, was engaged in the sale of consumer goods at discounted retail prices to its members and their guests at five locations in Southern California during the period in question. In return for a fee of two dollars, each qualified applicant received a non-assessable and non-transferable life membership certificate entitling him to enter appellee's premises and make purchases at a discount. The issue before the district court was

[1] See 206 F.Supp. 330 (D.C.Cal. 1962).

whether the fees were paid in exchange for "stock", within the meaning of that term as used in section 1032 of the Internal Revenue Code of 1954. The district court concluded that the membership certificates did represent "stock" for the purpose of section 1032.

The issue presented in this case is the same as that presented in Affiliated Government Employees' Distributing Co. v. Commissioner of Internal Revenue (No. 17985), decided by us this day. While there are a few factual differences between that case and the instant one,[2] the differences are not substantial and would not justify different results in the two cases. For the reasons stated in *Affiliated*, therefore, we conclude that the fees in this case were not paid in exchange for stock and constituted taxable income to appellee.

The judgment of the district court is reversed and the case is remanded for entry of judgment in favor of appellant.

(Endorsed) Opinion Filed Sept. 16, 1963.

Frank H. Schmid, Clerk.

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[2]For example, under appellee's by-laws a member was entitled, upon his request, to a refund upon resignation of his membership; in the event of a member's death, a refund was made, upon request of the deceased member's executor or administrator, to the member's estate. Prior to November 17, 1956, Affiliated Government Employees' Distributing Company's by-laws also provided for a refund of the membership fee upon the resignation or death of a member. On and subsequent to that date, however, refunds were left to the discretion of Affiliated's board of directors.

Another factual difference that was noted is that appellee has paid a federal excise tax on the issuance of its memberships, whereas it would appear that Affiliated has not paid this tax.

APPENDIX E.

[Title of District Court and Cause.]

MEMORANDUM OF DECISION.

Appearances: Messrs. Butterworth & Smith; Edward L. Butterworth, 618 South Spring Street, Los Angeles 14, California, Messrs. Dempsey, Thayer, Deibert & Kumler, Albert L. Burford, Jr., 1104 Pacific Mutual Building, Los Angeles 14, California, Attorneys for Plaintiff. Francis C. Whelan, United States Attorney, Lillian W. Wyshak, Assistant United States Attorney, 808 Federal Building, Los Angeles 12, California, Attorneys for Defendant.

Mathes, District Judge:

Plaintiff company brings this action, pursuant to 28 U.S.C. § 1340(a)(1) and § 7422(a) of the Internal Revenue Code of 1954 [26 U.S.C. § 7422(a)], for a refund with interest of Federal income taxes paid for the period July 1, 1956, through December 31, 1957, claiming that membership fees received by plaintiff during that period were improperly taxed as "income" by the Commissioner of Internal Revenue.

The evidence adduced at trial reveals no substantial controversy as to the material facts, which may briefly be stated as follows. Plaintiff, known generally as "Fedco", was incorporated under the laws of California as a nonprofit corporation [see Cal. Corp. Code § 9200] in August of 1949 and, during the period in question, was engaged in the sale of consumer goods at discounted retail prices to its members and their guests at five store and warehouse locations in Southern California. Membership was limited chiefly to government employees.

In return for a fee of two dollars, each qualified applicant received a non-assessable and non-transferable life-membership certificate entitling him, inter alia, to enter plaintiff's premises and make purchases at a "discount". No further or periodic payments were called for, since membership for life was acquired by payment of the initial two-dollar fee, subject, however, to revocation "for any cause deemed sufficient" by a two-thirds vote of the Board of Directors.

Regular members, comprising the bulk of the membership, were entitled under plaintiff's by-laws to vote for the election of directors, "all of whom shall be life members of the organization". Each member was also entitled to receive a pro rata share of all corporate assets remaining at the time of liquidation or dissolution. Upon the death of a member, the membership fees were refundable at the option of the estate of the deceased; and, unless refunded, the decedent's spouse would succeed to all privileges of membership, excepting only "the right to vote or hold office or serve on the Board of Directors of this Corporation."

As ground for the refund claimed, plaintiff contends that the membership fees in question constituted a "contribution to the capital" of the corporation within the meaning of § 118 of the Internal Revenue Code of 1954 [26 U.S.C. § 118], or were received "in exchange for stock" pursuant to § 1032(a) of the Internal Revenue Code of 1954 [26 U.S.C. § 1032(a)]; and that, in either case, such fees were exempted from inclusion in plaintiff's gross income. Plaintiff further urges that the membership fees cannot, in any event, be deemed income under the Federal Constitution, since the capital nature of the transactions pre-

cludes treating them as "income" within the scope of the Sixteenth Amendment; and so any Federal tax upon these fees would be subject to the further Constitutional requirement that direct taxes must be "apportioned among the several States" [U.S.Const., art. I, § 2, cl. 3], and "in Proportion to the Census" [U.S. Const., art. I, § 9, cl. 4].

In reply, defendant insists that the membership fees must be declared as "income", since they constituted nothing more in substance than payment for services to be rendered. [See Int. Rev. Code of 1954, § 61(a)-(1), 26 U.S.C. § 61(a)(1).] In the alternative, defendant further contends that, should such fees not be characterized as "income", then the Government would, in all events, be entitled to recoupment pursuant to § 362(c)(2) of the Internal Revenue Code of 1954 [26 U.S.C. § 362(c)(2)], resulting from a corresponding basis-reduction of depreciable property, namely, "furniture, fixtures, equipment, [and] leasehold improvements" acquired by plaintiff with the proceeds of the fees.

The term "gross income" has been defined as "all income from whatever source derived". [Int. Rev. Code of 1954, § 61(a), 26 U.S.C. § 61(a).] "And the [Supreme] Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted." [Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955).]

One such exemption is found in § 118(a) of the Internal Revenue Code of 1954, which provides that "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer".

This provision, without counterpart in any prior Code, was enacted to codify then-existing law as to contributions made by groups or individuals without proprietary interest in a corporation, since in many cases such contributions could neither be deemed gifts nor payments for services, and therefore should not be taxable as income. [See: H. R. Rep. No. 1337, 83rd Cong., 2d Sess. a 38 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 18-19 (1954).] Indeed, Treasury Regulation §1.118-1 [26 C. F. R. §1.118-1] declares "the exclusion [§ 118] does not apply to any money or property transferred to the corporation in consideration for goods or services rendered . . .".

Thus, the question of whether a payment to a corporation constitutes a "contribution to the capital of the taxpayer", within the meaning of § 118, is held to turn not only upon what is given or gained in return for the payment, but also upon the motive or purpose and intent of the person making the payment. [See: Brown Shoe Co. v. Commissioner, 339 U.S. 583, 591 (1950); Detroit Edison Co. v. Commissioner, 319 U.S. 98, 102-103 (1943); cf. Edwards v. Cuba Railroad, 268 U.S. 628, 632-633 (1925).] And these criteria have been applied even in cases where the "contribution" of a fixed amount has been found to be at least part-payment for services. [See: Teleservice Co. of Wyo. Val. v. Commissioner, 254 F. 2d 105 (3rd Cir.), cert. denied, 357 U.S. 919 (1958); Denver & Rio Grande Western Railroad Co., 32 T.C. 43, 45-46 (1959 aff'd. 279 F. 2d 368 (10th Cir., 1960); Warren Television Corp., 17 CCH Tax Ct. Mem. 1053 (1958); cf. United Grocers, Ltd. v. United States, 186 F. Supp. 724 (N.D.Cal. 1960).]

Here plaintiff concedes that the dominant purpose of applicants for membership in "Fedco" has been to "buy merchandise at pretty good prices" and it is plain that payment of the membership fees in return for this privilege constituted primarily payment for a direct benefit and service to the members and, as such, was not exempt from taxation as a "contribution to . . . capital" under § 118. [Cf., Brown Shoe Co. v. Commissioner, supra, 339 U.S. at 591; Community T. V. Ass'n v. United States, 203 F. Supp. 270, 272-274 (D.Mont. 1962).]

On the other hand, it is equally clear that any gain to plaintiff from receipt of membership fees is not taxable as income, if received "in exchange for stock" of the corporation within the meaning of § 1032(a). The inquiry turns, then, to whether plaintiff's membership certificates, issued in return for the membership fees, evidence "stock" as the term is employed in §1032.

In this connection, it is first to be noted that plaintiff's memberships were deemed by the California Commissioner of Corporations to be securities under the State Corporate Securities Law [see Cal. Corp. Code § 25008]; and, subsequent to incorporation, plaintiff applied for and received an official permit from the State Commissioner to issue the membership certificates involved herein [see Cal. Corp. Code §§ 25500-25515]. But it is to be borne in mind, nonetheless, that "The definition of words used in federal tax statutes is governed by federal law" [Cunha's Estate v. Commissioner, 279 F. 2d 292, 296 (9th Cir. 1960), cert. denied, 364 U.S. 942 (1961)]; for:

> "'It is the will of Congress which controls; and the expression of its will in legislation, in the ab-

sency of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation. . . . State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law". [Burnet v. Harmel, 287 U.S. 103, 110 (1932); see Lyeth v. Hoey, 305 U.S. 188, 193-194 (1938).]

Inasmuch as no definitive statutory language exists in the present instance, and no compelling statutory implication can be found which directs application of State law in defining the word "stock", neither the findings of the State Commissioner, nor the pronouncements of Cal. Corp. Code §§ 103 and 115 that "shareholder" and "shares of stock" include membership in nonstock corporations, can be controlling here. Accordingly, it is the duty of this Court to apply Federal law and give the term "stock" its "ordinary meaning", consistent with the policy and purpose of § 1032. [Cf. Little's Estate v. Commissioner, 274 F. 2d 718, 727 (9th Cir. 1960); see United West Coast Theatres Corp. v. South Side Theatres, 80 F. Supp. 109, 112 (S.D. Cal. 1949).]

Ownership of shares—"stock"—in a corporation has been characterized as "an individual interest giving the stockholder a right to a proportional part of the dividends and the effects of the corporation when dissolved, after payment of its debts". [First National Bank v. Maine, 284 U.S. 312, 329-330 (1932), overruled on other grounds, 316 U.S. 174 (1942).] Also, as an "interest or right which the owner has in the management, profits and assets of a corporation" [Com-

missioner v. Scatena, 85 F. 2d 729, 732 (9th Cir. 1936); cf.: Elko Lamoille Power Co. v. Commissioner, 50 F. 2d 595, 596 (9th Cir. 1931); Community T.V. Ass'n v. United States, supra, 203 F. Supp. at 274; and see United Grocers, Ltd. v. United States, supra, 186 F. Supp. at 729.] And one which need not be evidenced by any certificate of ownership. [See: In re Penfield Distilling Co., 131 F. 2d 694, 698 (6th Cir. 1942); Los Angeles Fisheries v. Crook, 47 F. 2d 1031, 1035 (9th Cir. 1931).]

Guided by these criteria, the conclusion must be that the membership certificates issued by plaintiff represented "stock" within the scope of § 1032. As already noted, plaintiff's regular members were entitled to participate in the management of the corporation through their right, without class distinctions, to vote for directors and to seek corporate office for themselves. Members were also entitled to share pro rata the remaining corporate assets upon liquidation or dissolution. It is significant, too, that there was no requirement that the membership be periodically renewed, or that dues be paid as a condition to continued participation in the affairs of the corporation; for plaintiff's members acquired membership rights for life upon making the single payment of the specified fee.

Moreover, in view of the emphasis given "a uniform application to a nationwide scheme of taxation" [Burnet v. Harmel, supra, 287 U.S. at 110], the conclusion that the membership certificates evidenced ownership of "stock" within the purview of § 1032 is buttressed by the fact that plaintiff was required to purchase stamps representing the Federal excise tax upon "each original issue of shares or certificates of stock, issued by a cor-

poration . . .". [See Int. Rev. Code of 1954, § 4301, 26 U.S.C. § 4301.]

Distinct and crucial differences appear, therefore, between membership in the plaintiff corporation and those wherein persons pay initiation fees or dues—renewable annually as a rule—to obtain services, without thereby acquiring any proprietary right or interest whatever in the corporation. [Cf.: American Automobile Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club v. Commissioner, 353 U.S. 180 (1957); Teleservice Co. of Wyo. Val. v. Commissioner, supra, 254 F. 2d 105; Keystone Automobile Club v. Commissioner, 181 F. 2d 402 (3rd Cir. 1950); Automobile Club of New York, Inc., 32 T.C. 906 (1959); and see: United Grocers, Ltd. v. United States, supra, 186 F. Supp. at 736; Chattanooga Automobile Club, 12 T.C. 967 (1949), aff'd. 182 F. 2d 551 (6th Cir. 1950); United Retail Grocers Ass'n, 19 B.T.A. 1016 (1930).]

The Government points out per contra that plaintiff's members were not allowed to share in corporate profits or dividends, and that their rights of participation, including the sharing of assets upon liquidation or dissolution, were neither assessable nor transferable and ceased whenever a membership terminated by death or otherwise. But these negative factors cannot overturn the conclusion that membership in the corporation constituted "stock" within the meaning of § 1032, since the sum of these restrictions upon the rights of members accord with State requirements and policy governing the operation of nonprofit corporations such as plaintiff. [See: Cal. Corp. Code §§ 9200, 9608, 9609.] It has been pointed out, furthermore, that "where taxable situations arise from relationships en-

tered into under state law, their nature and the rights of the parties under such law must be kept in view in determining the incidence of federal taxation". [Ward v. Commissioner, 224 F. 2d 547, 551 (9th Cir. 1955).]

Neither does the right of plaintiff's Board of Directors to cancel membership "for any cause deemed sufficient" militate forcefully against the conclusion that plaintiff's membership certificates represented "stock" in the corporation. Although "Memberships may be terminated in the manner provided in the articles or by-laws" [Cal. Corp. Code § 9608], "It is hornbook law that directors, while not strictly trustees, are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the stockholders. They owe a duty to all stockholders . . . and must administer their duties for the common benefit". [Remillard Brick Co. v. Remillard-Dandini Co., 109 C.A. 2d 405, 419, 241 P. 2d 66, 74 (1952); see Cal. Corp. Code §§ 820, 9002; cf. Bennett v. Hibernia Bank, 47 Cal. 2d 540, 559, 305 P. 2d 20, 32 (1956).] Indeed, the disputable presumption "that official duty has been regularly performed" is sustained by the evidence at bar, which establishes that plaintiff's Board of Directors was not abusive of the right to cancel memberships, no revocations at all having been made during the period in issue here. [See Cal. C.C.P. § 1963(15), (33).]

The conclusion that the membership certificates represented "stock" within the meaning of § 1032(a) leaves the question whether further inquiry should be made as to the motive or purpose and intent of the members in paying the fees, as under § 118 with respect to determination of capital contributions.

One possible construction of § 1032 is that the test of "money . . . in exchange for stock" requires examination of the motive which prompted the act and the intent with which the act was done, in order to ascertain whether fees paid for membership certificates, as in the present case, were meant to be "in exchange for stock", or were exchanged for services or other benefits. [Cf. Affiliated Gov't Employees' Distrib. Co., 37 T.C. No. 88 (February 12, 1962).]

However, I am of the opinion, for reasons now to be stated, that the proper test in determining recognition of gain or loss under § 1032 is whether "money or other property" was in fact surrendered to a corporation in return for its "stock", without regard to the motive or intent of either party to the transaction. [Compare Community T.V. Ass'n v. United States, supra, 203 F. Supp. 270.]

Section 1032 has no counterpart in the Internal Revenue Code of 1939, and the purpose of its enactment in 1954 was to remove uncertainties in then-existing law, where recognition of gain or loss was dependent upon "whether the transaction constitutes the dealing by a corporation in its own shares which is to be ascertained from all of the facts and circumstances". [H.R. Rep. No. 1337, supra, 83rd Cong., 2d Sess. a208; see: S. Rep. No. 1622, supra, 83rd Cong., 2d Sess. 426; Treas. Reg. 118, § 39.22(a)—15, 26 C.F.R. § 39.22(a)—15 (1953).]

By the enactment of § 1032, the question of corporate intent or purpose in determining whether or not the corporation was in fact "dealing" in its shares was eliminated as one of the determining "facts and cir-

cumstances", in keeping with the statutory pattern that issuance of stock in exchange for property should not generally be made a taxable transaction. [Cf.: Int. Rev. Code of 1954, §§ 305, 351, 354, 355, 361, 1032, 1036, 26 U.S.C. §§ 305, 351, 354, 355, 361, 1032, 1036; United States v. Anderson, Clayton & Co., 350 U.S. 55 (1955); General Electric Co. v. United States, 299 F. 2d 942, 945-947 (Ct. Cl. 1962); Girard Trust Corn Exch. Bank v. United States, 191 F. Supp. 551 (E.D.Pa. 1961).]

By the same token, then, § 1032 should not be construed to require a determination of motive or intent on the part of purchasers of a corporation's stock; otherwise the statutory purpose to objectify the applicable standard with respect to such transactions would be frustrated. Such a standard, as applied to § 1032, is emphasized in Treasury Regulation § 1.1032-1(a) [26 C.F.R. §1.1032-1(a)], which declares that:

> "The disposition by a corporation of shares of its own stock . . . for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved."

In keeping with this view, during the course of trial of the case at bar, evidence of the state of mind of purchasers of plaintiff's membership certificates was excluded under Fed.R.Civ.P. 43(c), on the issue as to whether "stock" transactions under § 1032 had occurred during the tax period in dispute. However, as already observed, such evidence has been held to be relevant to the issue of whether the membership fees were

capital contributions within the scope of § 118, and hence has been given weight in reaching the conclusion that the membership fees in question were not exempt as contributions to capital under § 118.

The nebulous criteria of motive and intent are difficult at best to apply in determining the incidence of any tax; and such criteria should never be resorted to unless their utilization is required by the language or prior construction of the particular statutory term or provision involved, as in the determination of a "contribution to the capital" under § 118.

It follows, then, that the membership fees paid to plaintiff during the period in controversy were not excludable from gross income as contributions to capital under § 118, but nevertheless were free from taxation as income, because received "in exchange for stock" under § 1032.

This holding works no conflict in purpose between the provisions of § 118 and § 1032 of the Internal Revenue Code. Nor does it create in § 1032 a shelter to which corporations and others may repair when similar transactions are held not exempt under § 118. For § 118, by its terms, deals solely with contributions to capital and, ex necessitate, does not apply where no contribution to corporate capital is intended, and where proprietary rights and interests in a corporation are directly received in return for money. [Cf.: Brown Shoe Co. v. Commissioner, supra, 339 U.S. at 591; Detroit Edison Co. v. Commissioner, supra, 319 U.S. at 103; Joy Mfg. Co. v. Commissioner, 230 F. 2d 740, 742 (3rd Cir. 1956); United Retail Grocers Ass'n, supra, 19 B.T.A. 1010.]

It is true of course that, "when applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder we must regard matters of substance and not mere form". [Weiss v. Stearn, 265 U.S. 242, 254 (1924).] The test here held to rule applicability of § 1032 is one of substance, in that basic stock attributes must be shown to exist and to be enforceable by members, before membership in a corporation such as plaintiff may be characterized as "stock".

Plaintiff provided each member with a direct and enforceable corporate right and interest, regardless of the motive or intent of each in purchasing the membership. That such a membership certificate was necessary for entry upon the business premises, that the cost of the membership was minimal, and that by December 31, 1957, membership included as many as 213,095 regular, and 79,904 associate members, all are factors which lead toward the conclusion that membership fees were not intended primarily as contributions to capital pursuant to § 118, but were payments made in return for direct benefits of purchase, as is indicated also by plaintiff's gross sales during 1957 of some 28 million dollars to members and their guests. But these facts are immaterial to the determination that what a member received in exchange for a monetary fee was indeed "stock" within the meaning of § 1032.

Accordingly, the question whether plaintiff's receipt of membership fees could Constitutionally be held to be "income" under the Sixteenth Amendment need not be reached and will not be decided, since in all events "no gain or loss shall be recognized" to plaintiff as a result of these transactions by virtue of § 1032. This does

justice to the admonition that a Constitutional issue should not as a rule be decided, even though properly presented, "if there is also present some other ground upon which the case may be disposed of". [Ashwander v. Valley Authority, 297 U.S. 288, 347 (1936) (concurring opinion); see United States v. Hayman, 342 U.S. 205, 223 (1952).]

Considering the membership fees in question to be subject to Federal income tax, but excluded from inclusion in plaintiff's gross income by virtue of § 1032 (a), the further question is presented whether the Government is entitled to recoupment pursuant to § 326 (c)(2) of the Internal Revenue Code of 1954 [26 U.S.C. § 362(c)(2)], which provides, inter alia, that if money:

> "(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and (B) is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. . . ."

By its own terms, the above-quoted provision is not applicable at bar, since receipt of the membership fees by plaintiff corporation is not deemed a "contribution to capital", as specified by § 362(c)(2)(A).

Subsection (c) of § 362 is without counterpart in the 1939 Code and, while determination of what comprises a capital contribution should be made "in accordance with the nature of the transaction", this provision is plainly directed to "situations similar to that which have occurred in . . . Brown Shoe Co. v. Commissioner . . . where property was contributed to a

corporation by persons other than its shareholders in their capacity as shareholders". [H.R. Rep. No. 1337, supra, 83rd Cong., 2d Sess. a128.]

In Brown Shoe Co. v. Commissioner, supra, 339 U.S. 583, community groups had transferred money and property to the corporation upon agreement that it construct, enlarge and operate factories for a minimum period as well as meet a minimum payroll in the community. The Court there held that the assets so acquired constituted "contributions to capital" within the meaning of § 113(a)(8)(B) of the Internal Revenue Code of 1939 [26 U.S.C. § 113(a)(8)(B)], thus requiring "no reduction in the depreciation basis of the properties acquired", in accordance with prior law [339 U.S. at 589]. Detroit Edison Co. v. Commissioner, supra, 319 U.S. 98, involving "contributions" by applicants for electrical service which were in fact found to be "the price of the service", was distinguished by the Court on the ground that "Since in this case there are neither customers nor payments for service, we may infer a different purpose in the transactions between petitioner and the community groups". [339 U.S. at 591.]

Thus the factors employed to determine what is and what is not a "contribution to capital" are the same under both § 118 and § 362 [cf.: H.R. Rep. No. 1337, supra, 83rd Cong., 2d Sess. a38, a127-128; S. Rep. No. 1622, supra, 83rd Cong., 2d Sess. 18-19], since § 362 merely sets forth the rules for computation of basis to corporations of property acquired, inter alia, by means of contributions exempted from inclusion as taxable income under § 118. In the case at bar, of course, it has been established that the membership

fees were received not as contributions to capital, but rather in exchange for stock.

Furthermore, since taxability of the transactions in controversy at bar is governed by § 1032, it is doubtful that § 362 could be applicable in any event. For aside from the fact that § 362(c) was enacted to deal with situations similar to that of the Brown Shoe Co. case, supra, 339 U.S. 583, the provisions of § 362 are referred to in § 1032(b) merely with respect to the "basis of property acquired by a corporation in certain exchanges for its stock", none of which apply here. And Treasury Regulation § 1.1032-1(d) sets forth the general rule that "For basis of property acquired by a corporation in a transaction to which section 1032 applies but which does not qualify under any other nonrecognition provision, see section 1012" [26 C.F.R. § 1.1032-1(d)]; which in turn provides that cost, without more, shall be the basis as to such property.

The conclusion that § 362(c)(2) is inapplicable because the fees involved cannot be termed a "contribution to capital", makes it unnecessary to decide whether the requirement of § 362(c)(2)(B)—that money from receipt of membership fees be "not contributed by a shareholder as such"—is satisfied in the circumstances at bar, nor whether plaintiff has established what property was "acquired" with such fees. [See Treas. Reg. § 1.362-2(a), 26 C.F.R. § 1.362-2(a).]

Accordingly, plaintiff is entitled to a refund of income taxes and interest paid upon the membership fees received during the tax period in question, and defendant's counterclaim for recoupment must be denied.

Judgment will therefore be entered in favor of plaintiff, together with interest in accordance with § 6611 of the Internal Revenue Code of 1954 [26 U.S.C. § 6611], each party to bear own costs.

The foregoing shall serve as findings of fact and conclusions of law [Fed.R.Civ. P. 52(a)], and plaintiff will lodge an appropriate judgment with the Clerk, to be settled pursuant to Local Rule 7, within five days.

[Endorsed]: Filed June 12, 1962.

APPENDIX F.

Taxation—Federal Income Tax—Taxability of Receipts From Sale of Membership Certificates

In two recent cases raising the issue of the taxability to a corporation of receipts from the sale of membership certificates the Tax Court and district court reached contrary results. In both cases non-profit California discount houses,[1] sold non-assessable, non-transferable membership certificates to applicants. These certificates entitled the member to purchase goods at a discount, vote for directors,[2] and share in the assets of the corporation upon dissolution. The board of directors of both corporations had the right to cancel membership certificates "for any cause deemed sufficient."[3] Upon the member's death, the membership fee was refundable. The only material factual difference between the two cases is that only one corporation (Federal Employees' Distributing Company) had been required

[1]The California corporations were organized under Cal. Corp. Code Ann. § 9200: "A nonprofit corporation may be formed . . . for any lawful purposes which do not contemplate the distribution of gains, profits or dividends to the members thereof and for which individuals lawfully may associate themselves, such as . . . for rendering services, subject to laws and regulations applicable to particular classes of nonprofit corporations or lines of activity. Carrying on business at a profit as an incident to the main purposes of the corporation and the distribution of assets to members on dissolution are not forbidden to nonprofit corporations, but no corporation formed or existing under this part shall distribute any gains, profits, or dividends to any of its members as such except upon dissolution or winding up."

[2]Even though the members had the technical right to vote, as a practical matter, this right was not exercised. Affiliated Gov't Employees' Distrib. Co., 37 T.C. No. 88, at 10 (Feb. 12, 1962), *appeal docketed*, No. 17985, 9th Cir., 1962.

[3]Federal Employees' Distrib. Co. v. United States, 206 F. Supp. 330, 332 (S.D. Cal. 1962); Affiliated Gov't Employees' Distrib. Co., *supra* note 2, at 2.

to pay the federal stock transfer tax on the membership certificates.[4] Procedurally there was also a difference: one suit was brought in the Tax Court on a tax deficiency,[5] whereas the other action was brought in the Federal District Court for the Southern District of California for a tax refund.[6] Both courts agreed that the receipts from the sale of memberships were not contributions to capital under section 118 of the Internal Revenue Code of 1954,[7] yet contrary results were reached because the courts differed on whether the membership certificates were stock under section 1032 of the Code. The Tax Court held the certificates were not stock, *Affiliated Government Employees' Distributing Co.*, 37 T.C. No. 88 (Feb. 12, 1962), *appeal docketed*, No. 17985, 9th Cir., 1962, while the district court held the certificates were stock, *Federal Employees' Distributing Co. v. Commissioner*, 206 F. Supp. 330 (S.D. Cal. 1962).

The Internal Revenue Code of 1954 made significant structural changes in the taxability of contributions by outsiders to a corporation.[8] One entirely new section of the Code concerns the taxability of an exchange

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[4]The tax was levied under Int. Rev. Code of 1954, § 4301 "There is hereby imposed [a tax], on each original issue of shares or certificates of stock issued by a corporation. . . ."

This is a stamp tax or document tax. Edwards v. Wabash Ry., 264 Fed. 610, 614-15 (2d Cir. 1920); Malley v. Bowditch, 250 Fed. 809, 811 (1st Cir. 1919).

[5]Affiliated Gov't Employees' Distrib. Co., *supra* note 2.

[6]Federal Employees' Distrib. Co. v. United States, *supra* note 3.

[7]Federal Employees' Distrib. Co. v. United States, *supra* note 3, at 333; Affiliated Gov't Employees' Distrib. Co., *supra* note 2.

[8]See, *e.g.*, Note, 66 Yale L.J. 1085 (1957).

of stock for consideration,[9] but nowhere in the Code is the indicia of stock provided.[10] Only sections 118 and 1032 of the Code are pertinent to this discussion. Section 118 excludes capital contributions to corporations from corporate gross income,[11] which is defined as "all income from whatever source derived."[12] The legislative history of section 118 indicates that existing case law was codified,[13] and section 118 exclusions were restricted to contributions to capital by individuals or organizations "having no proprietary interest in the corporation."[14] The other new provision, section 1032, provides that the exchange of a corporation's stock (including treasury stock) is not a taxable event to the corporation.[15] This section was designed to eliminate the taxation problem of gain or loss on treasury stock transactions by the corporation.[16] As a result of sec-

[9]Int. Rev. Code of 1954, § 1032.

[10]The only definition of stock in the Code appears in §7701(a): "(7) Stock.—The term 'stock' includes shares in an association, joint stock company, or insurance company."

[11]Int. Rev. Code of 1954, § 118. "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer."

[12]Int. Rev. Code of 1954, § 61(a).

[13]"This in effect places in the code the court decisions on this subject." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. 18 (1954).

[14]"It [§ 118] deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 17 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 18 (1954).

[15]Int. Rev. Code of 1954, § 1032(a). "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."

[16]"Section 1032, relating to the exchange by a corporation of its stock for property, has no counterpart under the 1939 Code

tion 118, the taxation problem of contributions to capital by outsiders has been minimized, while section 1032 resolves many problems concerning capital gains and losses on treasury stock transactions; yet problems of statutory interpretation concerning the meaning of the concepts of income,[17] capital,[18] and stock[19] still remain.

Under present law, whether the disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends, under certain decisions, upon whether the transaction constitutes the dealing by a corporation in its own shares which is to be ascertained from all of the facts and circumstances. The purpose of the section is to remove the uncertainties of the present law." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A268 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 426 (1954).

Before 1954, the issuance of stock was a non-taxable event. "The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock." Treas. Reg. 118, § 39.22(a)-15(a), 18 Fed. Reg. 5702 (1953) (now Treas. Reg. § 1.1032-1(a) (1956)). See also 7 Mertens, Federal Income Taxation §38.20 (Supp. 1962).

[17] Aside from the Code, income has been defined "as the gain derived from capital, from labor, or from both combined. . . ." Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415 (1913). In Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (1918), the Court said: "Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax, conveying rather the idea of gain or increase arising from corporate activities."

[18] "When used with respect to property of a corporation or association the term [capital] has a settled meaning: it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed." Bailey v. Clark, 88 U.S. (21 Wall.) 284, 286-87 (1874). In a recent case, United Grocers, Ltd. v. United States, 186 F. Supp. 724, 729 (N.D. Cal. 1960), the term capital was defined as "the money, property or means contributed by stockholders as the fund or basis for the business or enterprise for which the corporation was formed." See also 1 Dewing, The Financial Policy of

Prior to 1954, a significant body of case law concerning capital contributions was developed. In the leading case of *Edwards v. Cuba R.R.*,[20] subsidy payments by the Cuban government to a company for building a railroad were held to be a contribution to capital and not a taxable event. On the other hand,

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Corporations ch. 2 (5th ed. 1953); Harvey, *Some Indicia of Capital Transfers Under the Federal Income Tax Laws*, 37 Mich. L. Rev. 745 (1939).

[19]The term "stock" has posed a multitude of problems for the courts. See note 38 *infra*. "The word 'stock' is not uniformerly used to designate the capital of a corporation although its primary meaning is capital, in whatever form it may be invested. Shares are the mere certificates which represent a subscriber's contribution to capital stock, and measure his interest in the company." Wright v. Georgia R.R. & Banking Co., 216 U.S. 420, 424-25 (1910). "Shares of Stock are intangible and rest in abstract legal contemplation. They are the interest or right which the owner has in the management, profits and assets of a corporation. . . . A certificate of stock is a symbol or proper evidence of ownership of the shares; it is not the stock itself." Commissioner v. Scatena, 85 F.2d 729, 732 (9th Cir. 1936).

"[T]he essential fact remains that capital stock represents, at the last analysis, the ownership and the responsibility for management of the corporation and the rights to receive profits and experience losses from its operations as an enduring and functioning business enterprise." 1 Dewing, The Financial Policy of Corporations 57 (5th ed. 1953).

"The term 'stock' is sometimes used in the same sense as 'capital stock' or 'capital' and it has been said that 'its primary meaning is capital, in whatever form it may be invested.' But it is used more generally, perhaps, to designate the shares of capital stock in the hands of individual stockholders, or the certificates issued by the corporation to them." 11 Fletcher, Private Corporations § 5081, at 30-31 (rev. vol. 1958).

"The distinguishing feature of a stock is that it confers upon its holder a part ownership of the assets of the corporation and gives him a right to participate in the management of the corporation and to share in the surplus profits and in dissolution to share in the assets which remain after the debts are paid." *In re* Feehheimer Fishel Co., 212 Fed. 357, 360 (2d Cir. 1914). See Elko Lanoille Power Co. v. Commissioner, 50 F.2d 595, 598 (9th Cir. 1931).

[20]208 U.S. 628 (1925).

government subsidy payments to subsidize operating expenses or to maintain a certain level of income were held to constitute income to the corporation.[21] Subsequent cases extended the *Cuba Railroad* doctrine to private contributions for the construction of utilities,[22] although contributions to trade associations,[23] and to mutual benefit associations[24] were held to be income and taxable. Payments to potential consumers for the extension of utility services were said to constitute income in *Detroit Edison Co. v. Commissioner*,[25] thus it appeared that the doctrine of *Cuba Railroad* had been restricted. Later in *Brown Shoe Co. v. Commissioner*,[26] after distinguishing *Detroit Edison*,[27] the Supreme Court extended the *Cuba Railroad* doctrine to community contributions to induce industry to locate or expand existing manufacturing facilities in the community.[28] Therefore, it appears that the nature of

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[21] Texas & Pac. Ry. v. United States, 286 U.S. 285 (1932); Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932); Boston Elevated Ry. v. Commissioner, 131 F.2d 161 (1st Cir. 1942). See also Denver & Rio Grande W.R.R., 32 T.C. 43 (1959), *aff'd.* 279 F.2d 368 (10th Cir. 1960).

[22] See Tampa Elec. Co., 12 B.T.A. 1002 (1928); El Paso Elec. R.R., 10 B.T.A. 79 (1928); Wisconsin Hydro-Elec. Co., 10 B.T.A. 935 (1928); Liberty Light & Power Co., 4 B.T.A. 155 (1926).

[23] United Retail Grocers Ass'n, 19 B.T.A. 1016 (1930).

[24] Pontiac Employees Mut. Benefit Ass'n, 15 B.T.A. 74 (1929); Employees' Benefit Ass'n of Am. Steel Foundries, 14 B.T.A. 1166 (1929).

[25] 319 U.S. 98 (1943).

[26] 339 U.S. 583 (1950).

[27] *Detroit Edison* was distinguished because in this case, *Brown Shoe*, there were "neither customers [n]or payments for service. . . . The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large." *Id.* at 591.

[28] *Id.* at 593.

the donor and the purpose of the contribution are important factors in characterizing contributions as either capital or income.[29] This case law was codified in section 118.[30] Later cases have said dues paid to automobile clubs[31] and co-operatives[32] are income not capital. The recent television cases,[33] in which private companies sold "shares" to members of a community as a prerequisite for obtaining television reception, have presented the courts with the dual problem of what are contributions to capital under section 118 and what is stock under section 1032. Following *Detroit Edison*, the courts held that the payments were income for they were payments for services,[34] and the "shares" were not stock within section 1032 because an ordinary investor would not be interested in the shares.[35] The "thin corporation" cases[36] are a vivid illustration of

[29]See, *e.g.*, Note, 66 Yale L.J. 1085 (1957). See also 29 N.C.L. Rev. 198 (1951).

[30]Note 14 *supra*. One of the main objections by the Internal Revenue Service, prior to 1954, was that a company was allowed a depreciation deduction for property received as a capital contribution. Section 362(c) of the Code has eliminated this objection.

[31]See, *e.g.*, Automobile Club v. Commissioner, 353 U.S. 180 (1957); Keystone Auto. Club v. Commissioner, 181 F.2d 402 (3d Cir. 1950); Automobile Club, Inc., 32 T.C. 906 (1959). See also Chattanooga Auto. Club, 12 T.C. 967 (1949), *aff'd*, 182 F.2d 551 (6th Cir. 1950).

[32]See United Grocers, Ltd. v. United States, 186 F. Supp. 724 (N.D. Cal. 1960).

[33]Teleservice Co. v. Commissioner, 254 F.2d 105 (9th Cir.), *cert. denied*, 357 U.S. 919 (1958); Community T.V. Ass'n v. United States, 203 F. Supp. 270 (D. Mont. 1962); Warren Television Corp., 17 C.C.H. Tax Ct. Mem. 1053 (1958). See 107 U. Pa. L. Rev. 820 (1959), 44 Va. L. Rev. 1339 (1958), Note, 66 Yale L.J. 1085 (1957).

[34]*Ibid.*

[35]Community T.V. Ass'n v. United States, 203 F. Supp. 270, 274 (D. Mont. 1962).

[36]See, *e.g.*, John Kelley Co. v. Commissioner, 326 U.S. 521-

the complexities involved in determining tax consequences in terms of the attributes of certificates themselves.[37]

In the instant cases both courts agreed that the receipts from the sales of the membership certificates were not "contributions" to capital under section 118 as the receipts were payment for services.[38] The courts split on the issue of whether the sale of membership certificates was a stock transaction under section

(1946); Reed v. Commissioner, 242 F.2d 334 (2d Cir. 1957); Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956), *cert. denied*, 352 U.S. 1031 (1957); Kraft Foods Co. v. Commissioner, 232 F.2d 418 (2d Cir. 1956). See also Beniamin, *Thin Corporations—Whose "Substance Over Form?"*, 34 Tul. L. Rev. 99 (1959); Chaplin, *The Caloric Count of a Thin Corporation*, N.Y.U. 17th Inst. on Fed. Tax 771 (1959); Schlesinger, *"Thin" Corporations: Income Tax Advantages and Pitfalls*, 61 Harv. L. Rev. 50 (1947); Semmel, *Tax Consequences of Inadequate Capitalization*, 48 Colum. L. Rev. 202 (1948).

[37] *Ibid.* Practically all the circuits are agreed that the formal name of the certificate is not the determinative factor in ascertaining the nature of the transaction. "There is no one characteristic, not even exclusion from management, which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts. So-called stock certificates may be authorized by corporations which are really debts, and promises to pay may be executed which have incidents of stock." John Kelley Co. v. Commissioner, 326 U.S. 521, 530 (1946).

The name of the security does not determine its real character. Jewel Tea Co. v. United States, 90 F.2d 451, 454 (2d Cir. 1937); Armstrong v. Union Trust & Sav. Bank, 248 Fed. 268, 270 (9th Cir. 1918). *Contra*, First Mortgage Corp. v. Commissioner, 135 F.2d 121, 124 (3d Cir. 1943); Commissioner v. O.P.P. Holding Corp., 76 F.2d 11 (2d Cir. 1935).

The court will look through the form to the substance to determine the character of the security. Thompson v. Commissioner, 205 F.2d 73, 78 (3d Cir. 1953); Commissioner v. Pittsburgh & W. Va. Ry., 172 F.2d 1010, 1014 (3rd Cir.), *cert. denied*, 337 U.S. 939 (1949); Paxson v. Commissioner, 144 F.2d 772, 776 (3d Cir. 1944); Community T.V. Ass'n v. United States, 203 F. Supp. 270 (D. Mont. 1962).

[38] Federal Employees' Distrib. Co. v. United States, *supra* note 3; Affiliated Gov't Employees' Distrib. Co., *supra* note 2.

1032. The Tax Court looked through the form of the transaction to the substance[39] and held this was not a stock transaction because the dominant purpose of the member in purchasing the certificate was to participate in discount merchandising, the members were not entitled to share in profits, the membership certificate was subject to revocation by the board of directors "for any cause deemed sufficient," no indicia of ownership was issued except a wallet sized card which was essentially a pass, and the right to vote was theoretical rather than real.[40] The federal district court held that this was a non-taxable transaction within the scope of section 1032.[41] These certificates were stock, for the members were entitled to participate in management and on dissolution and share in the assets, no requirement was present for annual dues, the certificates were not required to be renewed, and the corporation was required to pay the federal stock transfer tax on the certificates.[42] The fact that members were not entitled to share in profits does not negate this conclusion for this was a requirement of a California corporation statute,[43] nor is the cancellation clause material because the directors were under a fiduciary duty toward stockholders.[44] The district court rejected the motive test[45] in determining the nature of

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[39] Affiliated Gov't Employees' Distrib. Co. v. United States, *supra* note 2.

[40] *Ibid.*

[41] Federal Employees' Distrib. Co. v. United States, *supra* note 3.

[42] *Id.* at 334.

[43] *Id.* at 335. See note 1, *supra*.

[44] Federal Employees' Distrib. Co. v. United States, *supra* note 3, at 335.

[45] See note 30 *supra* and accompanying text.

the transaction[46] and adopted the test of whether money or property had been received for the stock[47] because the legislative history of section 1032 indicates that intent or purpose was abolished in determining the nature of the transaction.[48] Furthermore, the criteria of motive and intent are nebulous and difficult to apply.[49]

The basic problem remains one of meaningfully defining stock for purposes of section 1032. To resolve this problem, the indicia of stock cannot be controlled by state law;[50] the solution must be sought from the Internal Revenue Code, its legislative history, and its policies. The Tax Court reached the correct conclusion, although the analysis of the problem by the district court is superior to that of the Tax Court.[51] As a result of misinterpreting the legislative history of section 1032, the district court reached an undesirable conclusion. The legislative history of section 1032[52]

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[46]Federal Employees' Distrib. Co. v. United States, *supra* note 3, at 336.

[47]*Id.* at 335.

[48]*Id.* at 336.

[49]*Ibid.*

[50]"The exertion of that [federal] power is not subject to state control." It is the will of Congress which controls, and the expression of its will in legislation, in the absence of language evidencing a different purpose, is to be interpreted so as to give a uniform application to a nationwide scheme of taxation." Burnet v. Harmel, 287 U.S. 103, 110 (1932).

[51]Commenators have frequently argued that tax litigation should be within the exclusive province of the Tax Court for other federal courts are not familiar with the complexities and ramifications of tax law. See *e.g.*, Griswold, *The Need for a Court of Tax Appeals*, 57 Harv. L. Rev. 1153 (1944); Lowndes, *Federal Taxation and the Supreme Court*, in The Supreme Court Review 222 (1960); Pope, *A Court of Tax Appeals: A Call for Re-examination*, 39 A.B.A.J. 275 (1953). The instant cases appear to refute this argument for the federal district court thoroughly analyzed the problem whereas the Tax Court decided the problem at hand with very little analysis.

[52]See note 16 *supra*.

and previous Treasury Regulations[53] clearly indicate that Congress was only concerned with the problem of taxing gains and losses on treasury stock transactions and did not consider the definitional aspects of "stock."[54] The cases indicate that there is no general rule to determine the characteristics of stock for all purposes.[55] For the purpose of section 1032 the following criteria are useful in determining what is stock. Would an ordinary investor desirous of earnings or appreciation (growth) consider purchasing the stock? Is the purported stock a means of procuring capital for the corporation or is the issuance of the stock designed to accomplish some other purpose? A merchant-consumer relationship between the corporation and the shareholder is another factor of relevance.[56] The membership certificates in these cases possessed some indicia of stock, yet the certificates, in substance, were illusory stock because an investor, not interested in discount purchasing, would not acquire the stock. Rather, the primary purpose of the certificates was to serve as a pass to enable members to gain entrance to the premises and to participate in discount merchandising. The fact that the federal document tax was paid on the certificates by one corporation does not contravene this conclusion, for the document tax is levied on the form of the certificate,[57] not on the substance of the transaction. The policy of such tax is obviously different. Besides, the relevant legislative history[58] does not indicate any policy to benefit discount merchandising.

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[53] *Ibid.*

[54] *Ibid.*

[55] See Edwards v. Walbash Ry., 264 Fed. 613, 614-15 (2d Cir. 1920); Malley v. Bowditch, 259 Fed. 809, 811 (1st Cir. 1919).

[56] See note 10 *supra*.

Taxation of the receipts from the sale of membership certificates will not appreciably affect discount selling, whereas a non-taxable status to these receipts will be an impetus to discount sellers to utilize comparable customer selection arrangements which offer them a windfall tax benefit.

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Sec. 61(a) (26 U.S.C. 61 (a)) 2, 4
Sec. 118 (26 U.S.C. 118) 4
Sec. 1032 (26 U.S.C. 1032) 2, 4

In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 777

AFFILIATED GOVERNMENT EMPLOYEES' DISTRIBUTING COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. 16-33) is reported at 37 T.C. 909. The opinion of the court of appeals (Pet. App. 3-15) is reported at 322 F. 2d 872.

JURISDICTION

The judgment of the court of appeals was entered on September 16, 1963. (R. 184.) Petitioner was

granted an extension of time within which to file its petition for a writ of certiorari to and including January 22, 1964. The petition was filed on January 22, 1964. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether the membership fees paid to the taxpayer by its members, for the privilege of buying goods at the taxpayer's stores at a discount, were includible in the taxpayer's gross income as compensation for services or were exempt from taxation as amounts received in exchange for stock.

STATUTES INVOLVED

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

(26 U.S.C. 61.)

SEC. 1032. EXCHANGE OF STOCK FOR PROPERTY.

(a) *Nonrecognition of Gain or Loss.*—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange

for stock (including treasury stock) of such corporation.

* * * * *

(26 U.S.C. 1032.)

STATEMENT

Taxpayer, a nonstock membership corporation, was organized in 1953 under the General Nonprofit Corporation Law of California and, during the years in question, was engaged in the retail sale of consumer goods at discounted prices to its members and their guests (Pet. App. 4). Membership in the corporation was limited generally to government employees—who paid a fee of $2—and to veterans—for a fee of $3 (Pet. App. 5).

Memberships were for life, terminated automatically upon death; they were nontransferable and were represented by a wallet-sized pass card which was used to identify the holder for admittance to taxpayer's stores. Memberships were subject to revocation for any cause deemed sufficient and refunds of the fee either upon death or resignation were within the discretion of the board of directors. Members had the right to vote for management and the right to share in assets upon dissolution, but they did not share in the profits or in the potential growth of the corporation during its life (Pet. App. 13).

Taxpayer failed to include the membership fees in its gross income for the periods in question and the Commissioner assessed deficiencies against it—$26,718.64 for the fiscal year ended June 30, 1956, and $46,188.48 for the fiscal year ended June 30, 1957—

on the ground that the fees were properly includible in gross income as compensation for services (Pet. App. 16-17, 18). In the Tax Court, taxpayer contended that the membership fees were exempt from taxation—either as contributions to capital under Section 118 of the 1954 Code or as amounts received in exchange for stock under Section 1032 (Pet. App. 30-31). The Tax Court found that the fees were paid for the privilege of shopping at taxpayer's stores and did not qualify for either exemption (Pet. App. 32). In the court of appeals, taxpayer conceded that the fees were not contributions to capital, but contended that the Tax Court erred in failing to find that the fees were received in exchange for stock (Pet. App. 3). The court of appeals affirmed on the ground that the membership fees were received in exchange for the privilege of shopping at taxpayer's stores at a discount and "were thus paid solely for direct benefits to be received" from the taxpayer (Pet. App. 15).

ARGUMENT

The decision below is correct and, contrary to taxpayer's assertions, no conflict of decisions or constitutional issue is involved.

According to Section 61(a) of the Internal Revenue Code of 1954, *supra*, p. 2, "gross income means all income from whatever source derived, including * * * compensation for services" and this Court has repeatedly held that the broad language of this provision reflects the intent of Congress to exert "the full

measure of its taxing power" and to "tax all gains except those specifically exempted". *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-430. The taxpayer in the instant case is a nonstock membership corporation organized under the California General Nonprofit Corporation Law. See Corporations Code, 25 West's Annotated California Codes, Sections 9000-9802. Section 9200 of that code provides that a nonprofit corporation may be formed for religious, charitable, social and educational purposes, as well as for the purpose of "rendering services." Taxpayer renders a service to its members by making available to them, through the medium of mass buying power, a broad line of consumer goods at lower prices than could be obtained through normal retail outlets (Pet. App. 8, 31). It acts, in a sense, as a conduit or agent through which many individual consumers are enabled to pool their buying power in order that goods may be purchased by the group in larger quantities at lower prices, with a resulting saving to each individual member. A qualified individual who wishes to avail himself of the taxpayer's service is required to pay a two or three dollar membership fee. Though he receives a membership card which serves the purpose of identifying him as a member in order that he may enter taxpayer's stores and make purchases at a discount (Pet. App. 8), it is readily apparent, as both courts below concluded (Pet. App. 13-15, 31-32), that the membership fees received by the taxpayer were paid by the members for the privilege of shopping at taxpayer's stores at a discount, and were

therefore properly includible in taxpayer's gross income as compensation for services under Section 61 (a)(1). See *United Grocers, Ltd.* v. *United States*, 308 F. 2d 634 (C.A. 9th); *James Hotel Co.* v. *Commissioner*, (C.A. 10th) decided November 29, 1963 (12 A.F.T.R. 2d 6035); *Community T.V. Assn. of Havre* v. *United States*, 203 F. Supp. 270 (D. Mont.).

Taxpayer's principal contention is that taxing the membership fees is unconstitutional and that the decision below is in conflict with a decision of this Court and decisions of other courts of appeal.* The argument is premised on the erroneous assumption that the fees were received in exchange for stock and therefore represent equity capital. But the fact is that, while the memberships had some of the indicia of stock—i.e., the right to vote and to share in assets on liquidation—these factors, when examined in context, were insufficient to elevate the members to the dignity of stockholders and to negate what were, in substance, payments made for services rendered. The relationship between taxpayer and its members was that of merchant-customer, the membership fee was small, and refund of the fee either upon death or resignation was solely within the discretion of the board of directors. Memberships terminated automatically upon the death of a member and members

* The cases cited (Pet. 6-7), *Eisner* v. *Macomber*, 252 U.S. 189; *Commissioner of Internal Revenue* v. *Fleming*, 82 F. 2d 321 (C.A. 5); and *Nicholas* v. *Fifteenth Street Inv. Co.*, 105 F. 2d 289 (C.A. 10), merely emphasize that the Sixteenth Amendment grants power to tax "income" alone, not "capital".

did not share in the profits of the business. The memberships were nonassignable and could be revoked at any time by the board of directors "for any cause", in which case the membership fees would not be refunded (Pet. App. 13). Very few members ever attended a membership meeting (Pet. App. 11, 14-15) and neither the member nor his estate was assured of a share in any distribution in the event of liquidation (Pet. App. 31-32). In short, as the court of appeals aptly pointed out (Pet. App. 15), the members received nothing of substance in exchange for their fees "other than the privilege of buying goods at a discount". Accordingly, taxpayer's contention that the fees were received in exchange for stock rather than for services rendered, is without merit.

The instant decision is not in direct conflict with the decision of any other court of appeals. The alleged impact of the decision on all other nonstock companies in the United States (Pet. 10-12) ignores the care taken by the court of appeals to limit its holding to the facts of this (and the related) case (Pet. App. 14-15).

CONCLUSION

The decision of the court below is correct, and, in any event, presents no issue warranting review by this Court. The petition for certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

October Term, 1963
No. 777

AFFILIATED GOVERNMENT EMPLOYEES DISTRIBUTING COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REPLY MEMORANDUM OF PETITIONER.

The issue presented in the instant case is the same as that presented in *Federal Employees Distributing Company v. United States of America*, No. 778. Petitioner incorporates herein by reference the reply brief filed this date in said *Federal Employees Distributing Company v. United States of America*.

The petition for a writ of certiorari in the instant case should be granted for the reasons set forth in the reply brief in *Federal Employees Distributing Company*

v. United States of America, No. 778, and this matter should be heard on the merits or, in the alternative, remanded to the Court of Appeals for the Ninth Circuit for proper consideration of the constitutional issue duly raised by petitioner.

Respectfully submitted,

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Counsel for Petitioner.